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Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes seven/two to raise Bank Rate in December

In its most recent e-mail poll, finalised on 25th November, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) decided by seven votes to two that Bank Rate should be raised on Thursday 5th December. Four SMPC members voted for a ¼% increase, three members voted for a rise of ½%, and two wanted to leave rates unaltered. This pattern of votes would deliver an increase of ¼% on the usual Bank of England voting procedures.

There were two main reasons why a majority of the SMPC thought that it was now necessary to start a gradual and phased process of raising Bank Rate towards a more normal level. One reason was the feeling that the hyper-low interest rates appropriate in the 'lender of last resort' period some half-a-dozen years ago were no longer required. In addition, it was feared that such abnormally low rates of interest were encouraging financial and property speculation at the expense of savers and genuine wealth-creating investment and damaging potential growth in the longer term. A second reason for wanting a rate increase was the strength shown by recent business surveys and the official growth figures. The SMPC poll was largely completed before the release of the second estimate of third quarter UK GDP on 27th November. However, this showed unrevised quarterly and annual increases of 0.8% and 1.5%, respectively. The two main reasons for wanting to hold rates were the belief that there remained ample unused capacity in the domestic economy and concern that the problems in the Eurozone had abated – but not been resolved – leaving a potential threat to UK export demand and activity.

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. 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. As a result, the nine independent analyses should be regarded as more significant than the exact vote. The next quarterly SMPC gathering will be held on Tuesday 14th January and its minutes will be published on Sunday 2nd February. The next two SMPC e-mail polls will be released on the Sundays of 5th January and 2nd March, respectively.

For Further Information on the Content Please Contact:

David B Smith + 44 (0) 1923 897885 xxxbeaconxxx@btinternet.com
Philip Booth + 44 (0) 20 7799 8912 pbooth@iea.org.uk
Richard Wellings + 44 (0) 20 7799 8919 rwellings@iea.org.uk

For E-Mail Distribution Enquiries Please Contact:

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

Comment by Phillip Booth

(Institute of Economic Affairs and Cass Business School)
Vote: Raise Bank Rate by ½%.
Bias: Hold QE and start to reverse.

Problems on the supply side cannot be solved by an easy monetary stance

The widespread view that monetary policy is sufficient on its own to deal with problems that stem from the real side of the economy is worrying and likely to bias the economy towards stagflation rather than healthy long-run growth. Most of the underlying problems facing the British economy are on the supply-side and cannot be tackled by monetary means. In particular, the planning system needs reforming to allow people to move from low to high productivity areas of the country. Because the interest rate levied on private sector borrowers has become disconnected from the central bank REPO rate, this is a particularly good time to normalise rates because the knock on effects will be less marked than normal. The immediate need is to begin the process of getting back to *real* rates of interest of the order of 2% to 2½%. Bank Rate should be raised by ½% in December, and QE should be on hold with a bias to reverse in the longer term.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: Neutral.

A solid recovery has emerged

A solid UK recovery has finally emerged. Annualised growth in real GDP of 2¾% in the second quarter was followed up by growth of 3¼% in the third. These are preliminary numbers but survey evidence is consistent with an even more robust upswing if anything. Early estimates of market sector output (= GDP minus activity in the government and non-profit sectors) which should be more closely aligned to business surveys reveal an even faster expansion. At least in the near-term, rapid growth should continue. Reported inflows of new business have so far been even stronger over the autumn than they were over the summer. Indeed, the new business sub-index in the monthly service sector Purchasing Managers Index (PMI) report hit a record high in October (the series starts in July 1996). In addition, the evidence concerning firms' inventories highlights a growing shortfall since the second quarter. Consistent with anecdotal evidence from the business sector, the pick-up in demand appears to have taken many firms by surprise. Re-stocking through the second half of the year could be a powerful support to overall output growth.

And the fog of uncertainty appears to be lifting

Elevated uncertainty has previously been a major headwind to the recovery. However, now the fog of uncertainty appears to be lifting. Business confidence in a recovery is increasing. This is filtering through to investment intentions, although rapid growth is not yet indicated. Consumer confidence has also been revived: there has been an especially large decline in unemployment fears, which would be expected to foster reduced precautionary household saving. In conjunction with lower mortgage rates and slowly improving access to mortgage credit, increased consumer confidence is boosting the housing market, especially in London where prices are increasing sharply. Monetary indicators are also consistent with a continuation of the recovery through 2014, although potentially one with less vigour than we have seen recently. Annual broad money growth has been in the 4% to 5% range since last summer, which given past trends in velocity, would not be sufficient to bring about a sustained

period of above-trend growth. With no real revival in lending volumes expected, it is unlikely that broad money growth will pick up from here.

Potential shifts in money velocity could have an expansionary effect

However, there are reasons to believe that money velocity will diverge from the trend of the last two decades. This could be a direct effect of efforts to subsidise bank funding and support lending, such as the Funding for Lending Scheme (FLS): companies and households with better access to bank credit facilities are less likely to hoard money balances. Especially within the business sector, there is scope for existing cash balances to be 'put to work'. Other factors, such as reduced uncertainty (e.g. about the Eurozone's future), would have similar effects. Nominal GDP growth could therefore remain solid even if broad money growth (specifically, $M4^{ex}$) was broadly unchanged. Indeed, there is already tentative evidence of this taking place. Despite little change in the relative rate of return on immediately accessible bank deposits in recent months, there has been a big portfolio shift towards such monetary assets. Household and non-financial firms' M1 (demand deposits and cash) expanded at an annualised rate of 13% in the six months to September, a rate last seen in late 2004. A surge in 'on-demand liquidity' could suggest an increasing propensity to utilise already created money balances - i.e., a rise in money velocity.

But good news is not a reason to raise Bank Rate

The good news is welcome. Nevertheless, it is not a reason to tighten monetary policy. Indeed, we are still some way from that point. The economy is operating well below capacity. Slack is considerable in the labour market, albeit it is less evident within companies. It is highly uncertain whether the prolonged slump in productivity will be reversed in a recovery. Some of the damage will be permanent. Nevertheless, much will not be if, but only if, the UK enjoys a sustained pick-up in demand. This is only one reason for keeping exceptionally easy policy for some time. However, there are others. Domestically-generated inflation is quiescent: 'core' Consumer Price Index (CPI) inflation (adjusted for the entirely artificial effect of recent tuition fee hikes) is currently 1.4%; regular nominal hourly pay in the private sector was unchanged compared with a year earlier. Given the lagged effects of lower commodity prices and weak global price pressures, underlying UK inflation should be well below 2% through 2014.

Risks to growth and inflation remain on the downside

Importantly also, risks to growth and inflation remain on the downside. The global economy is far from healthy. While a decent US recovery appears to be in train, the Eurozone crisis bubbles away. The Monetary Policy Committee's (MPC's) central expectation of annualised quarterly growth in the Euro-area of 1% in the near-term, and even faster growth beyond that, seems particularly optimistic. Since Britain is a small, open economy, the case for tighter policy at the first signs of an incipient recovery that could be knocked off course by several external shocks is weak.

Comment by Anthony J Evans

(ESCP Europe)
Vote: Raise Bank Rate by ½%.
Bias: Further rises in Bank Rate.

Rising inflationary expectations show Bank credibility is fading

If the Bank of England were narrowly following their remit, the continued above target inflation combined with increasingly positive growth forecasts should imply a belated attempt to start raising interest rates. It is true that inflation has fallen to 'just' 2.2% but inflation expectations seem to be adjusting to previous, higher inflation rates and it would be dangerous to ignore them. In October, the inflation rate for education was

10%, down from 20% in September. That seems to have been what was driving high inflation throughout 2013. However, education inflation was only 5% throughout late 2011 and early 2012 and CPI inflation was over 3%. Even if the cause of inflation is temporary factors, if temporary factors keep appearing, they should not be ignored. In October, a 'YouGov' survey saw inflation expectations for the forthcoming year to be above 3%. This is likely a blip, but should not be dismissed lightly. All nine of the Bank's own indicators of inflation expectations show that their credibility is being questioned.

Surveys suggest growth accelerated in the fourth quarter

The Business Activity Index and all-sector PMI are indicating that fourth quarter growth will be even higher than in the third, and this should be a cause for concern. Not only in terms of the inflationary pressure from such a sharp jump in growth, but that it is unlikely to be sustainable. The policy goal should not be to get credit flowing if this simply props up a housing bubble or encourages zombie firms to bet on future growth. The Chancellor's own budget depends on optimistic growth forecasts but this charade should be criticised, not emulated.

Need for credible communications strategy

In certain circumstances, it is understandable for the Bank to switch their focus from inflation, or at least tolerate above target inflation in the short run. However, this must be part of a credible communication strategy. Forward guidance has attempted to provide this but, so far, it seems to be failing. The Bank already seem to be moving away from the threshold of 7% unemployment, and are even questioning how good this measure is as a proxy for spare capacity. It is a bit like begging the barman for a lock in, having promised faithfully that you would go home after last orders. In some ways, forward guidance is like a currency band. It can reduce uncertainty provided market expectations are close to the policy target. However, it also introduces a new layer of uncertainty, relating to the commitment to the policy. The 'guidance about guidance' that we see is evidence of fault lines appearing and may indicate that it introduces more uncertainty than it quells.

'Chatter' and 'volatility' measures indicate increased uncertainty

Uncertainty is an important issue because it provides a coherent explanation for observed reductions in investment that accompany financial crises. The Bank of England appear to be taking uncertainty seriously with the adoption of a new index that looks at the frequency of certain phrases in various newspapers. Other – and, perhaps, more methodologically well grounded – attempts to measure uncertainty will look at volatility, and in particular spreads between various assets. Both these 'chatter' and 'volatility' measures are looking for proxies and are flawed. Nevertheless, they do support the view that uncertainty matters. And the relevance here is that the introduction of uncertainty tends to be a result of policy failure. In particular, the idea that we have a balance sheet recession caused by over indebted households may be explained instead by the idea that we have an excess of money demand caused by high levels of uncertainty.

Money is not too tight and growth would be higher if rates were normalised

Narrow money and broad money supply measures have dropped slightly over recent months and this may be a cause for concern if they continue to do so. However, with broad money growth consistently above 4% there is no obvious problem with money being too tight. Monetary policy could be a lot looser. However, this is more likely to make things worse than improve them. Growth would be higher, and more sustainable, if interest rates were at their natural rate and this is likely to be higher than the current policy rate.

Comment by Graeme Leach

(Institute of Directors)
Vote: Hold Bank Rate and QE.
Bias: Neutral.

Prospects have improved in line with accelerated money growth

Prospects for the UK economy look better than at any time since the financial crisis. On the basis of preliminary Office for National Statistics (ONS) estimates for 2013 Q3, GDP has grown by around 1.8% this year. This is double the rate of growth seen over the entire 2011-12 period. The first signs of the upturn appeared just over a year ago, with an expansion in the growth of the $M4^{ex}$ broad money supply measure towards 3% year-on-year. The initial expansion was relatively weak. However, it subsequently accelerated to around 5% in yearly terms in the first half of 2013, slipping back slightly towards 4.3% over recent months. The latest detailed statistics show household broad money rising by 4.4% on an annual basis and Private Non-Financial Corporations M4 increasing by 7.9%.

And expansion is feeding through to the wider economy

This expansion is now beginning to feed through into the wider economy. Thus far in 2013, around half of the growth in GDP has come from consumer spending. Consumption is likely to continue to underpin growth, for two reasons. Firstly, faster output and productivity growth, together with higher profitability (supported by lower unit labour costs), will permit companies to grant higher pay awards, boosting real disposable income. Over recent years, inflation has been running well ahead of earnings growth. However, that story is likely to change in 2014, with a narrowing and then reversal of this gap by the end of the year. Second, stronger consumer confidence, helped by wealth effects from a strengthening housing market, will permit modest further reduction in the household savings ratio towards 4% next year. Greater demand certainty; significant cash balances, and catch-up effects from foregone investment, suggest that business investment will play a more significant role in the recovery next year. Again, however, the overall effect will be modest.

But it is a modest little recovery

When told that Prime Minister Attlee was a modest man, Churchill replied that; *"he's a man who has much to be modest about"*. So it is with this modest recovery, due to the supply-side constraints imposed by statist intervention over recent decades and banking sector weakness in the wake of the financial crisis. GDP growth may edge above 2% in 2014, but such growth is unlikely to last beyond the first half of 2015. Potential output growth in the UK is probably at 2% or below, leading to higher inflation in 2015, and a tightening in monetary policy, if the actual growth rate exceeds potential. Spare capacity and sub-3% GDP growth rate mean that any future tightening in monetary policy is likely be modest also.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate and allow QE to wind down as redemptions fall due.

UK recovery has continued apace

The UK recovery continues apace, with recent manufacturing output and investment plans surveys looking especially strong. Unemployment is falling, though it may disappoint over the medium term as companies that hoarded labour during the recession use existing staff before taking on new workers. Nevertheless, pay rises –

which were suppressed significantly during the extended period of depression – are likely to pick up markedly as workers seek to catch up and thus share in growth.

But Eurozone problems have not been resolved

The main dark point is the Eurozone, where problems in Greece appear to be re-emerging and general monetary growth is poor. However, overall the UK monetary authorities have an opportunity to normalise policy to some small extent. They should take it.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE by £25bn per month.

Taking stock of monetary policy at year end 2013

This past year has been an eventful one in monetary and regulation policy. The key event has been politicians' realisation that the regulative mania had gone too far and was stopping the flow of credit to small businesses and housing – the flow to large businesses was being reversed anyway by their unwillingness to invest in the uncertain climate and the lack of competitive rivalry from new small business entry. It was clear that the UK recovery had stalled and the lack of credit flow was a key cause. With this realisation came a series of back-door offsets to the regulative obstruction to credit: a second FLS and the Help to Buy scheme. Close on the heels of these offsets, came the new Bank of England Governor, Mark Carney, with a mission from the Chancellor to revive the UK banking system. Mr Carney has by now started to talk about his support for UK banking and the build-up of its balance sheet; as far as he is concerned, he said, he saw no reason to complain if its balance sheet reached higher multiples of GDP in coming years, as long as it was done safely and ethically. Thus has the Bank moved to restore its relations with UK banks and about time too. The Bank of England is supposed to be the banks' friend at court, as well as the institution that casts a weather eye over their behaviour.

Benefits of more relaxed regulation

We are now beginning to see some fruits from this new approach to regulation. Credit is starting to flow – notably to the housing market, and not just to the ever-hot London market but all around the country. The stories are coming in of shortages of builders, bricks and so forth; mothballed sites are springing into development, and there is the start of a housing recovery. For those that see this as a 'bubble', it is worth reminding them that real house prices are about 30% below their peak. However, it is clear that the deregulation we are seeing is lopsided. Housing, and through it construction, is seeing the benefit of new credit, Small and Medium Enterprises (SMEs) are not. This is because, besides being subsidised by these HM Treasury schemes, mortgage finance has a low risk-weighting in the regulatory capital requirement, whereas SME loans have a high weighting. Banks are fine-tuning their credit to avoid raising more capital; especially, as this is currently very expensive for them given the poor equity rating for banks.

Regulation will have to be rethought to maximise economic welfare

This suggests regulation will have to be rethought. It is penalising the very sort of credit that banks are uniquely capable of providing, viz. to SMEs. Large firms can issue equity and bonds; SMEs basically cannot. There are business angels, there is peer-to-peer lending, there are venture capital firms and private equity; but fundamentally these are quite marginal to SMEs – though if banks continue to shun them, this will be forced to change. From the viewpoint of macroeconomic welfare we

should have institutions that keep the cost of credit for SMEs as close to the social cost of credit as possible. This can be defined as the safe rate of interest plus the cost of diversified investment risk (the equity risk premium). Current regulations are driving it well above this level.

Need for increased banking competition and new operating rules for monetary policy

Yet when we reflect on what went wrong in the pre-crisis period it seems fairly clear that: a) the world had an over-strong boom, fuelled by extremely stimulatory monetary policy through most of the 2000s; b) banks were not properly supervised in several countries where central banks had been given 'independence' and had had their supervisory role curtailed or removed, the UK being a prime example, and c) larger banks acquired a size and market power that was excessive. These considerations point to the need for more bank competition and smaller banks; and for central banks to resume their supervisory role. It also points to the need for new operating rules for monetary policy, including for QE – the newly revived Open Market Operations of central banks. These new operating rules should prevent future credit booms and busts; inflation targeting alone has failed to do this. I would suggest a new rule for the setting of the monetary base that explicitly targets credit/money growth and the credit premium – as important an interest rate as the one now being targeted, for government short-term bonds. With such new rules we can allow the new regulative system to ensure general safety with the minimum of intrusion into commercial decisions on loans.

UK recovery is strong, banks have vast liquid reserves, and monetary policy needs to be cautiously tightened

Turning finally to UK monetary policy today, I believe we need to plan for 're-entry' to a normal monetary environment. The UK recovery is now strong, fuelled by a fast-recovering housing market, owing to the partial pullback of regulation and the competitive drive this has created among banks. Banks have vast liquid reserves, thanks to QE. There is little to restrain them from pouring a mass of credit into this channel. The housing recovery will fan outwards into the rest of the economy, creating a typical if much delayed recovery spike, all of this in a pre-election period when politicians will be strongly against any tightening. The Bank needs to move pre-emptively to prevent money and credit getting out of control. At the same time it needs to get the regulative balance back more in favour of SMEs. So, finally, I suggest that QE be gradually reversed and that Bank Rate be increased in two-monthly steps of 0.25% over the next year, beginning at once.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)
Vote: Raise Bank Rate by ¼%; hold QE.
Bias: Avoid regulatory shocks; aggressively break up state-dependent banks; raise Bank Rate to 2% to 2½%, and gradually run off QE.

Background to the Autumn Statement

The Chancellor of the Exchequer will be announcing his Autumn Statement on Thursday 5th December, after the present note will have gone to press. However, it is almost certain that much of its content will be pre-released sequentially in the newspapers from Sunday 1st December onwards if the official news managers follow their normal routine. The evidence is that Mr Osborne will be in the unusual position, for him, of being able to announce that the Office for Budget Responsibility (OBR) will have revised its growth forecasts upwards and its public borrowing projections down since the March Budget. The latest independent consensus forecast compiled by HM Treasury shows a forecast for economic growth this year of 1.4%, followed by 2.3% in 2014, and a PSNB of £101.9bn in 2013-14, being followed by a deficit of £90.3bn in

2014-15. The latter will be the last full financial year figure to be reported ahead of a May 2015 general election and will be a politically sensitive figure. The medium-term forecasts published by HM Treasury, which incorporate a rather smaller sample of forecasters, suggest that economic growth will run at some 2¼% to 2½% between 2015 and 2017, while the PSNB is expected to gradually decline before reaching £76.3bn in 2017-18, assuming current policies are maintained after the general election.

OBR forecasts tend to be close to the independent consensus

The OBR creates its own independent forecasts for release alongside the Budget and the Autumn Statement. However, these are not significantly different to the consensus normally, particularly when the scale of revisions to past ONS data is borne in mind as well as the inevitable uncertainties involved in predicting the future. As it happens, the latest Beacon Economic Forecasting (BEF) projections, run using the 27th November GDP release – the consensus obviously suffers from some compilation and publication delays – are slightly above the consensus view where national output is concerned. Economic growth is expected to average 1.4% this year, and 2.6% in 2014 and 2.8% in 2015 before easing to just over 2% in 2016 and 2017. The PSNB is expected to come in at £98.4bn in the present financial year, decline to £91.9bn in 2014-15 and ease thereafter to reach just over £71bn by 2017-18.

Public finances better than projected in March 2013 but far worse than intended in May 2010

On the surface, this looks a reasonably hopeful picture. However, borrowing is far worse than Mr Osborne intended after the 2010 general election, and all such projections tend to rely on assumptions about public spending that assume more discipline in the future than has been achieved since the coalition took office. My BEF forecasts use the March OBR forecasts for the volume of general government investment but assume that the far greater volume of general government final consumption is held flat throughout the forecast period, rather than contracting in line with the official forecasts. The ONS national accounts for the post-electoral period between 2010 Q2 and 2013 Q3 show that the volume of general government current expenditure has risen by a total of 2.2%. However, general government investment had contracted by 7.7% between 2010 Q2 and 2013 Q2, which is the latest figure available. During the post-electoral period up to the third quarter, real household consumption has expanded by 2.8% and the basic-price measure of GDP has gone up by 3.2%. However, there are disturbing signs that spending ministers are getting itchy fingers and want to ease up on governmental spending discipline for electoral reasons. Since we are still deep in the dark woods of fiscal profligacy, any such easing has the potential to derail the painfully slow progress in righting the public accounts achieved so far. It is also worth noting that the peak period of intended retrenchment on the spending side has yet to come and may never happen. This is because Mr Osborne foolishly decided in 2010 to backload his spending cuts and frontload his tax increases. This action was perverse from the viewpoint of fiscal consolidation and may have set back the recovery by some twelve or eighteen months.

Britain is now back on the treadmill of relative economic decline, even when compared to a debilitated OECD

Britain has a small, open and trade-depending economy whose annual growth moves almost in lockstep with that of its Organisation for Economic Co-operation and Development (OECD) equivalent over the business cycle, and has done so for four or five decades. As a result, no British Chancellor has more than a tentative influence over economic developments. The best that any Chancellor can hope to achieve is to improve the growth gap between the UK and the OECD by pursuing fiscal discipline, low taxes and vigorous supply-side reforms. Unfortunately, the present Coalition has been too timid to take this course. The result is that the ratio of UK to OECD GDP is

again showing the declining trend that was such a marked feature of the Pre-Thatcher years. This is particularly concerning given the sharp slowdown in OECD growth since 2008. By international standards, the UK has been underperforming on growth and inflation, badly underperforming on its international trade, and has an extremely poor fiscal position. There is no scope for complacency or giving up on austerity on the public spending side. However, well-designed tax cuts would almost certainly be more than self-funding, given the massive distortions and disincentive effects created by Britain's onerous and complex tax system and should be pursued with boldness and vigour for economic reasons, not cheap political ones.

The need for a super-accommodating monetary stance is now past

Where does this leave UK monetary policy? First, the situation that originally justified a ½% Bank Rate and QE was clearly far worse a few years ago and the need for a super-accommodating stance has now gone. The real economy is picking up and the normal forecasting error at this point in the cycle is to underestimate growth not to overstate it. Second, UK broad money on the $M4^{ex}$ definition is growing at a reasonable rate (4.3% in the year to September) and also in the OECD area as a whole (5.2% in the year to the third quarter). Furthermore, Divisia money has been going through the roof, with a yearly increase of 9.3% and a rise of 9.5% excluding other financial corporations. Third, there are also signs from confidence surveys that the vitally important international background is improving, even if this has not yet been reflected in the official statistics. The Euro-zone still looks like a badly repaired vase, held together with sticky tape, which could crack open at any moment. However, it appears to be holding together for the time being. Fourth, the drop in annual UK CPI inflation from 2.7% in September to 2.2% in October was partly a reflection of a distortion caused by the introduction of student fees a year earlier. However, it was also a reflection of an easing in the price of oil. Lower energy costs help to explain why annual CPI inflation in the US eased from 2% in July to 1% in October and from1.6% to 0.7% in the Euro-zone over the same period. Reductions in the price of oil – and also non-oil commodities where the Economist magazine's weekly US$ based index fell by 11.7% in the year to 19th November – act as an indirect tax cut where the developed economies are concerned. That is they are both disinflationary and output expanding and any consequent easing in inflation is not a harbinger of a renewed downturn. Unfortunately, having fallen to US$103.5 on 7th November, the price of a barrel of Brent crude has risen more recently to reach US$110.9 on 26th November. On balance, however, the above factors suggest that a move towards a more normal nominal and real short term rate of interest is now justified.

However, a strong pound and need to avoid sudden shocks suggest rate hikes should be cautious and phased

The main reason for not being super-hawkish has been the recent strength of sterling, with the trade-weighted index standing at 83.8 (January 2005=100) on 26th November. Clearly, this will put pressure on what remains of Britain's low value-added internationally trading sector but probably not on the sale of more complex products. The sensitivity of export and import demand to price competitiveness appears to have fallen sharply since the 1960s. This is because items traded internationally have become more specialised and sophisticated, while price inelastic services have taken a growing share of UK exports. In addition, any aggregate demand loss arising from the trade account is likely to be more than offset by the expansionary consequences of lower inflation on living standards and a reduced need for precautionary savings. Nevertheless, policy makers have clearly been walking on egg shells since 2008 because confidence has been so brittle. This means that sudden and abrupt policy changes are best avoided. My vote is for Bank Rate to be raised by ¼% in December, and then to be raised cautiously in a pre-announced fashion, by ¼% increases every

second month or so until it is in the 2% to 2½% range, after which a pause for breath might be desirable. Likewise, the appropriate approach to QE is to allow it to gradually unwind as stocks mature, through a process of partial re-placement, but not to attempt anything too aggressive.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%; no extension of QE.
Bias: To raise Bank Rate.

Hard to be constructive about UK monetary policy

It has become ever harder to find anything constructive to say about UK monetary policy. The recovery of the UK economy in 2013 should not be a surprise in the light of the FLS and the Help-to-Buy scheme, both of which were essentially HM Treasury initiatives. FLS has lowered the average variable ISA deposit rate from 2.6% in July 2012 to 1.26% currently and the average instant access deposit rate (including bonus) from 1.55% to 0.75%. These savings rate cuts have funded cheaper mortgage rates and greatly assisted the revival of mortgage lending and refinancing activity. Annual M4 growth has surged to 2.6% and annual M4 lending growth has tipped into positive territory recently. In turn, these schemes have boosted housing construction, consumer spending and consumer confidence.

Superfluous Bank of England

The Bank of England's decisions on Bank Rate and the size of the QE programme have been superfluous, so far as one can tell. Household interest rates for deposits and loans rose when there was increased competition in the banking sector and fell when depositors were out-bid by the FLS. Bank Rate was ½%, throughout. It is the Treasury that has changed the cost of borrowing over the past eighteen months, not the Bank. The Bank's new conditional 'forward guidance' regime introduced in August is already ripe for overhaul. The unemployment rate in the Labour Force Survey jumps around violently from month to month because it is based on different samples rather than being a longitudinal study. After smoothing out the figures, it looks as if the 7% threshold for the unemployment rate will be breached (from above) around the middle of next year. However, the Bank insists that this will not be the arbiter of its rate decision. On some survey measures, UK inflation expectations have risen over the past few months and this could be interpreted as a threat to the knockout clause. However, the Bank has dismissed the rise in expectations as unreliable and to be ignored. All that remains of Bank of England monetary policy is a form of calendar guidance, whereby the Monetary Policy Committee (MPC) influences Sterling interest rate markets through its indications that Bank Rate will not be raised for some considerable period, regardless of the real GDP growth rate, the unemployment rate, the inflation rate, or measures of inflation expectations.

Twin Budget and current account deficits pose a threat to Sterling and the MPC can no longer control events

For the time being, gilt yields have tracked US bond yields fairly closely and gilts remain competitive internationally. Should the strong international bid for UK gilts fail for any reason, the combination of a £100bn per annum public borrowing requirement and a 4% of GDP current account deficit might present a few problems for the value of Sterling, with feedback effects on the inflation rate. While the MPC may approve of the economic score-line, they are mere spectators shouting from the touchlines. In order for the Bank to step back on to the pitch, the MPC needs to reconnect Bank Rate to the structure of market interest rates – traditionally between deposit rates (0.75%) and the standard variable mortgage rate (4.3%). A helpful innovation where QE is concerned would be to rebalance its stock of asset purchases away from gilts into

some private sector assets, such as infrastructure assets or commercial property. My vote is for Bank Rate to be raised, initially by 25 basis points, towards a target of at least 1.5%.

Comment by Mike Wickens

(University of York and Cardiff Business School)
Vote: Raise Bank Rate by ¼% and decrease QE to £250bn.
Bias: Slow monetary tightening over time.

Recovery has finally taken hold

The key feature of the UK economy for monetary policy is, as the November *Inflation Report* starts by saying, "recovery has finally taken hold" and the economy is "growing robustly". Although inflation is not yet reflecting this, as it fell in October to 2.2% from 2.9% in June, the time has come to look forward and slowly start to unwind loose monetary policy. The longer term aim should be to return the monetary stance to normal levels, i.e. a bank rate of about 3.5% to 4.0% and no QE.

Inconsistent UK monetary stance

At present, there are several inconsistencies in the monetary stance of the MPC which may explain their inertia. First, the MPC has made a point of introducing forward guidance to try to manipulate market expectations of interest rates. Even the economists polled by Reuters expect Bank Rate to flat-line in the future. Nonetheless, in its own forecasts, the MPC has chosen to use the forward market interest rate curve, which is rising.

Targeting a lagging indicator, such as LFS unemployment, leads to interest rate over-steering

Second, although the economy is growing and inflation, already above the target of 2%, is likely to increase further in the near term, the MPC continues to stress that it will not raise interest rates unless unemployment has fallen to 7%. Hitherto the MPC has argued that it takes about two years for interest rates to fully affect inflation. This requires monetary policy to be forward looking. The inconsistency here is that unemployment is a lagging indicator of market tightness and hence inflation. Not only is the new framework for monetary policy by the MPC therefore inconsistent with previous policy but, more worryingly, the MPC is now likely to respond far too late to rising inflation.

Feeble business investment has not responded to monetary stimulus

Third, the main reasons for low growth have been negligible business and housing investment. Consumption is now rising strongly with the savings rate, previously over 8% in 2008, now falling steadily. This probably explains the strong pick up in housing growth which will almost certainly add to future inflation. In contrast, business investment continues to contribute negatively to growth. It should, therefore, be clear by now that recent monetary policy based on a low price of credit and a banking system awash with liquidity does not stimulate business investment when expectations are of no, or weak, growth.

Sterling a major part of monetary transmission mechanism

Fourth, the exchange rate has always played an important role in the economy. Based on the Bank of England's previous macro model, I estimated that, in the first year, 80% of the impact of interest rates on inflation came via the exchange rate. The recent monetary stance has kept sterling weak. Not surprisingly, therefore, a major factor in higher than target inflation has been rising import prices. Moreover, in the second quarter, imports increased by 2.9%.

Phased rate hikes are less disruptive

These four inconsistencies all point to the need to tighten monetary policy now rather than wait until unemployment falls to 7%, which may not happen until late next year.

By that time, inflation may be even further above target. Another reason for tightening monetary policy now is the need to return it to normal levels. Achieving this in an orderly and measured manner would be far better for the economy than through a sudden large tightening that disrupts markets and results in a harmful misallocation of resources.

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 and University of Derby). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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London Tel: +44 (0) 20 7246 7870 london@lombardstreetresearch.com

New York Tel: +1 212 367 7644 newyork@lombardstreetresearch.com

Hong Kong Tel: +852 2521 0746 hongkong@lombardstreetresearch.com

Lombard Street Research

Independent • Objective • Creative

Pellipar House, 9 Cloak Lane, London EC4R 2RU

www.lombardstreetresearch.com