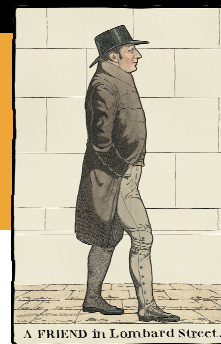


# Shadow Monetary Policy Committee

January 2012



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## IEA's Shadow Monetary Policy Committee votes unanimously to hold Bank Rate in January

In its most recent monthly e-mail poll, completed on 3<sup>rd</sup> January, the Shadow Monetary Policy Committee (SMPC) voted unanimously that UK Bank Rate should be held at ½% when the official rate setters make their announcement on Thursday 12<sup>th</sup> January. The overwhelming reason most SMPC members voted, in some cases reluctantly, to hold the official interest rate in January remained their grave concern over the potential adverse effects of the Euro-zone crisis on British banks and exporters. Some 'holds' thought that the 4.8% consumer price inflation recorded in November was bad enough to have justified a Bank Rate increase under more normal circumstances. However, there was a widespread view on the shadow committee that the measures adopted by the Euro-zone authorities were insufficient to stabilise the situation in the Euro Area and that the UK would just have to live with that fact.

There were two further concerns shared by several SMPC members. One was that the British economy had suffered a supply-side withdrawal, so that the negative output gap relied upon to bear down on inflation was smaller than the authorities believed. The second concern was the inconsistency between the official hard-line approach to financial regulation and the need to maintain the supplies of money and credit to sustain private job-creating economic activity. Raising capital requirements now was a classic example of a perverse, business-cycle exacerbating, regulatory shock. The authorities would do better to re-instate the Special Liquidity Scheme, whose brutal and premature withdrawal has badly damaged the credit creation process.

The SMPC itself 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 deeper issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. 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 nine independent SMPC analyses should be regarded as being more significant than the precise vote. The latter is not intended as a forecast of what the Bank of England will do but a declaration of what the shadow committee believes it should do. The next quarterly SMPC gathering will take place on Monday 16<sup>th</sup> January and its minutes will be published on Sunday 5<sup>th</sup> February. The next two SMPC e-mail polls will be released on the Sundays of 4<sup>th</sup> March and 1<sup>st</sup> April, respectively.

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### Comment by Roger Bootle

(Deloitte and Capital Economics)

**Vote: Hold Bank Rate.**

**Bias: Increase Quantitative Easing and carry on increasing it as necessary.**

#### Situation remains perilous

The economic position continues perilous. An outright fall in GDP is expected for this year with little sign of a revival on the horizon. The good news is that commodity prices have started to fall and inflation now looks likely to embark on a large and protracted drop. This may sow the seeds of economic recovery in due course. However, this remains a hope for the future rather than a current reality. In addition, the fall in inflation gives welcome cover for the authorities to increase Quantitative Easing (QE) still more. They should carry on and complete the existing programme as soon as possible and immediately announce more, and still more, and yet more, as necessary. Moreover, with the turmoil in the Euro-zone there is a significant chance that the pound will be forced up much higher against the Euro. If this happens, it would worsen the UK position and undermine confidence. The Bank of England should be ready to do Quantitative Easing (QE) across the exchanges – i.e. buying foreign assets, and even to take a leaf out of the book of the Swiss National Bank, standing by for even more aggressive currency interventions.

### Comment by Jamie Dannhauser

(Lombard Street Research)

**Vote: Hold Bank Rate.**

**Bias: Additional QE; unless Euro-zone situation improves markedly.**

#### UK recovery hangs in the balance

The fate of the UK recovery hangs in the balance. There is now a good chance that real GDP declines in at least one quarter in 2012. This primarily reflects the weakness of demand in the Euro-zone economy, which is Britain's main export destination. The Euro Area probably entered recession in late autumn, with output in some of the smaller periphery economies in decline since the summer. Italy is the first major European economy to tip back into recession; others will soon follow. Euro Area output is unlikely to start growing again until the second half of 2012 at the earliest.

#### Mixed data for US and China

Beyond Europe, recent economic data have been mixed. Consistent with the rebound in US broad money and business lending growth that begun in the first half of last year, there has recently been a pick-up in the underlying pace of domestic demand growth. The substantial decline in the real value of the dollar has improved US exporters' price competitiveness and boosted output via import substitution. In the emerging world, recent data releases have suggested a moderation in the pace of economic expansion. China, which has been a major source of global demand growth at the margin, seems to be slowing sharply, as efforts to rein in its banking sector start to bite.

#### Largest co-ordinated international fiscal consolidation since World War II

Even before one factors in the increasing likelihood of a disaster in Europe, there are sound reasons for believing that this year will be a difficult one for the world economy. Policy tightening to ward off inflation in the emerging economies implies weaker growth than in 2010 and 2011. While the temporary extension of the payroll tax cut in the US limits the immediate fiscal squeeze, policies worth 3% to 5% of GDP are set to be implemented in 2012/13 in order to bring down the US budget deficit. In aggregate, the advanced economies will be buffeted by the largest, co-ordinated fiscal consolidation in the post-war era.

#### Spectre of banking disaster has returned

Were these the only risks to the global growth outlook, the current stance of UK monetary policy might be considered appropriate. There would be certainly a strong argument for waiting to see how fast inflation falls back in the first half of this year in order to assess, with greater clarity, how weak *underlying* inflationary pressures actually are. However, with the spectre of banking disaster once again hanging over us, there are strong arguments for additional Bank of England

asset purchases. Commercial banks already appear to be responding to funding tensions by reducing the availability of credit and increasing its cost. Even before this tightening of monetary conditions has fed through to real activity, the UK economy appears to have stalled. Unless financial-market conditions improve markedly in coming weeks, an additional dose of QE will be needed. Given the ongoing disruption to medium-term bank funding markets, the government should consider inviting the Bank of England to purchase bank bonds alongside gilts. While the former may have a less immediate impact on broad money – e.g. because the Bank is purchasing debt directly from the banking sector – it would help assuage banks' funding problems, thereby limiting the deleveraging process that already appears to be underway.

#### **Comment by John Greenwood**

**(Invesco Asset Management)**

**Vote: Hold Bank Rate.**

**Bias: Hold Bank Rate; expand QE further if M4<sup>ex</sup> broad money declines.**

#### **Three questions concerning the outlook for 2012**

The fate of the world economy, the prospects for financial markets, and the international framework for the decisions of the Monetary Policy Committee (MPC) in 2012 depend primarily on the answers to three big questions: Will the Euro-zone crisis be resolved in a timely and effective manner? Will the US economy maintain its recent better performance? And will the Chinese economy avoid a hard landing in 2012?

#### **Euro-zone slipped back into recession in late 2011; its weakness will threaten UK export prospects in 2012**

The answers to these questions are not all favourable. First, the outlook for the euro-area remains clouded by the failure to resolve the region's sovereign debt problems at the Brussels summit on 8<sup>th</sup> & 9<sup>th</sup> December, and there is a possibility of another crescendo in the crisis during 2012. This will continue to cast a shadow over Euro-zone business and consumer confidence. Real GDP growth for the single currency area was only 0.2% quarter-on-quarter in the second and third quarters of 2011. The subdued growth was due to the drag from the crisis economies which offset stronger growth in Germany and France. The survey data so far available – such as the Purchasing Managers Index (PMI) which remained below 50 for the three months September-November – indicates that the Euro-area economies are almost certain to have shifted to recession in the final quarter of last year. Another decline in economic activity is likely in 2012 Q1 followed by very low growth for the balance of the year. This, together with a weakening Euro, implies adverse market conditions for UK exporters.

#### **US economy has not responded to stimulatory measures**

Second, in the US the recent improvement in performance following the soft patch last summer has been only partial, with the overall economy likely to be held back in 2012 by many of the same headwinds that eroded performance in 2011. One example is that the traditional macro-economic tools of fiscal and monetary stimulus proved impotent when confronted with the greater power of private sector deleveraging. Thus, the fiscal stimulus passed in December 2010 – which extended the Bush tax cuts, lengthened unemployment benefits and reduced the payroll tax – and the second programme of QE conducted by the Federal Reserve between November 2010 and June 2011 both failed to revive the economy. Although lower inflation should help revive real consumer incomes, 2012 is likely to be another year of sub-par growth.

#### **China excessively dependent on external demand**

Third, the Chinese economy remains excessively dependent on external demand and hence acutely vulnerable to the deepening downturn in Europe. This means that China's overall growth rate this year seems likely to be lower than in 2010 or early 2011, even though domestic monetary and fiscal stimulus will almost certainly be employed in 2012.

#### **Balance sheet repair and high inflation**

Turning to the factors driving the UK economy, balance sheet repair and the erosion of household income by higher than expected inflation were the two main headwinds holding back the economy in 2010 and last year. While balance

sheet repair is likely to continue to be a major preoccupation of both the household and financial sectors for several more years, inflation is likely to fall significantly in 2012. Nevertheless, continued deleveraging and weak real income growth will prevent a sudden snap-back to pre-crisis economic growth rates.

**Output gap and productivity growth are both inherently difficult to quantify**

Official views, as expressed in the Office for Budget Responsibility's (OBR) *Fiscal and Economic Outlook* and the Chancellor's *Autumn Statement*, have been very gloomy about the economic prospects for 2012 and 2013. On the positive side, both documents have at last displayed a welcome sense of reality in contrast to the previous tendency in Whitehall to persistently overestimate growth prospects and hence over-commit to government expenditure. On the negative side, the framework that the OBR uses to forecast growth depends on two concepts – the output gap in the economy, and the underlying growth of productivity – that are both extremely hard to quantify. Both of these have been problematic recently. The amount of excess capacity is inherently a nebulous concept, especially in a service economy. The OBR has argued that productivity growth has taken a permanent adverse hit because of the recession and will take many years to recover. On this basis, the OBR is forecasting only 0.7% real GDP growth in 2012 and 2.1% in 2013.

**Financial crises impair potential growth**

However, one can reach the same conclusion more directly. Much recent research has shown that growth is significantly impaired in the aftermath of a financial crisis. The reason is that financial crises damage balance sheets across the economy, and it takes a long time for the household and financial sectors to repair them. These are precisely the two sectors that became most over-indebted during the credit bubble of 2003 to 2008. Consequently I would say that essentially the official Whitehall view has at last come broadly into line with my forecast of sub-par, 1.0% real GDP growth in 2012.

**UK inflation upsurge was a 'one off'**

On the inflation front, commodity prices were pushed up strongly in 2009 and 2010 on the back of the recovery in the emerging economies, especially natural resource-importing economies such as China and India. The feed-through to consumer prices in very open economies such as the UK was rapid, exacerbated by weak sterling and higher VAT and fuel duties. However, this recent episode of inflation was essentially a one off event rather than the start of a sustained, continuing inflation. In 2012, the recession in the Euro-zone together with weak monetary growth in the US and the UK over the past two years will mean that these one off effects will largely fall away. This means that rising inflation will be replaced by a deceleration. Annual Consumer Price Index (CPI) inflation is expected to fall to 2.4% for this year as a whole, enabling real incomes to increase marginally – a considerable improvement over 2011. Against this only slowly improving background, Bank Rate should be kept at its current ½% level. The Bank of England should also be prepared to extend again its programme of asset purchases to ensure that M4<sup>ex</sup> monetary growth remains positive, but in low single digits.

**Comment by Ruth Lea**

**(Arbuthnot Banking Group)**

**Vote: Hold Bank Rate and no more QE as yet.**

**Bias: Towards more QE.**

**Third quarter UK GDP figure was misleadingly buoyant**

The increase in GDP in the third quarter was misleadingly buoyant. The revised 0.6% rise was driven almost entirely by a sizeable increase in inventories. There was some pick-up in fixed capital formation and a modest rise in General Government consumption, but household consumption was flat (and 1% lower than a year earlier) whilst the balance on net exports, very disappointingly, deteriorated. The much needed rebalancing of the economy from domestic to external demand, 'export-led growth', hit the buffers reflecting renewed

economic difficulties in the Euro-zone. Recent trade data confirm that exports of goods and services to the EU fell in 2011 Q3.

**GDP has been boosted by public spending and stock building but neither can continue indefinitely**

The December MPC minutes made a very telling point. They said that “*around three-quarters of the cumulative increase in GDP since the trough in the second quarter of 2009*” was attributable to government spending growth and an increase in inventories and “*private final demand had been subdued*”. Given the outlook for public sector spending and the extent of stock-building since 2010 Q2, neither of these growth drivers is likely to boost growth in future to the extent that they have done in recent quarters.

**Downbeat official growth forecasts are completely reasonable**

Under these circumstances the gloomy forecasts from the OBR, the Bank of England and the Organisation for Economic Co-operation and Development (OECD) are entirely reasonable. The OBR, for example, projected a modest GDP fall in 2011 Q4 and virtually flat growth in the first half of 2012 as their central case in November, cautioning that there was roughly a one-in-three chance that the UK would fall back into recession over the next three quarters. However, much depends on the Euro-zone’s performance. The OBR assumed that the bloc would muddle through and not implode. It said, with admirable constraint, “*...the possibility of a more disorderly outcome represents a significant risk on the downside to our forecast, but one that is impossible to quantify in a meaningful way given the range of potential outcomes.*”

**Euro-zone political leadership is inadequate to the task**

Suffice to say the Euro-zone’s political leaders failed, yet again, to deliver anything approaching a feasible package to ‘save’ the Euro-zone at their December Summit. One senses that the world is growing tired of Europe’s confidence-wrecking muddle and would like some resolution, whichever way, sooner rather than later. The OECD recently stated “*...imbalances within the Euro area, which reflect deep-seated fiscal, financial and structural problems, have not been adequately resolved. Above all, confidence has dropped sharply as scepticism has grown that euro area policy makers can deal effectively with the key challenges they face.*” There is, in other words, an increasing feeling that today’s Euro-zone’s leaders are incapable of sorting out the mess.

**Damaging effects of the unresolved Euro-zone crisis**

Mme Lagarde also chipped in recently, warning of a 1930s-style depression if the problems of the Euro-zone were not dealt with. She made it clear that “*...the core of the crisis at the moment...is obviously the European countries and in particular the countries of the Euro-zone*”. In addition, the Obama administration has expressed its concern that, without swift and decisive action from Europe, the region’s debt crisis could damage the fragile US recovery and the president’s re-election efforts. One suspects that the world will have to wait some time for ‘swift and decisive action’ from Europe. In the meantime, the Euro-zone economy is heading back into recession, damaging British growth prospects.

**Weakening labour market limits inflation risk**

Unsurprisingly, the labour market is weakening and, with earnings growth subdued, there are no signs of a ‘wage-price spiral’. Prices inflation surely will moderate in 2012. Under these circumstances, there is no justification for any change in interest rates for the foreseeable future. Concerning further QE, there is no need for any announcement at the 12<sup>th</sup> January MPC meeting. However, further QE may well be needed if the economy slumps back into recession.

#### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: Hold Bank Rate; hold QE.**

**Bias: To raise rates rapidly if Euro does not collapse within four months.**

**Sluggish growth prevents households servicing their debts**

UK index-linked gilt yields are highly correlated with long-term economic growth. Their message has for some time been that the UK will struggle to grow at above 1% over the next decade. If that does happen, then households will be unable to service their debts and there will be widespread bankruptcies, unless



inflation rises substantially. Current official policy appears to be to try to keep households clinging on, through maintaining policy interest rates at approximately zero, even if that comes at the expense of inflation and significant further deterioration in the value of the pound.

### Time for policy to change course

I have been an advocate and supporter of this policy up to now. Nevertheless, it cannot be right to maintain such a policy for more than an emergency period. In 2007, the economy clearly needed a very significant adjustment. There is a proper role for macroeconomic policy in attempting to smooth major economic adjustments just enough that they do not produce so much distress as to undermine social order. Policy can also act so as to limit overshooting. It seems clear that the UK economy has not overshot by any means – policy has almost certainly intervened at a very early stage and at a very large magnitude, so that it retarded the process of adjustment, rather than prevented overshooting. Thus far, we have undershot.

### Policy of protecting the over indulgent has gone on long enough

It is arguable that policy has smoothed what might otherwise have been such a large adjustment that it would have damaged orderly transition – perhaps through creating (more) investor panic or (more) liquidity problems or even (more) social disorder. Nevertheless, even this motivation has its limits. How long is it morally defensible to protect those that over-indulged and that made mistakes at the expense of those that were more prudent and restrained? A policy that can be perfectly correct if implemented over a year or two years might be the wrong policy if it must be repeated for ten years.

### Demand management policies are exhausted

We are very close, now, to the point at which demand management has done all it can, and should leave the fray. The proposition is that there should be a rapid normalisation in interest rates – perhaps to 3.5% over a four- or five-month period. Unfortunately, the timing of the Euro-zone crisis makes that inapposite at present. However, the Euro-zone crisis has gone on for some time. Even so, a resolution may be enforced by around March, when the Greeks are likely to run out of money. So, it could be appropriate to wait until then. However, and if the Euro has not collapsed by April, it will be time to assume it will not. The need then would be to press ahead with what must eventually be done – that is unless the path of inflating away debts is being seriously offered as a ‘policy’? If the Euro does indeed collapse, then we are into dark times. QE will probably not be the correct instrument at that point – we may need to print money to directly fund government spending, rather than second-hand debt. However, that lies ahead. For now, again we wait.

### Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

**Vote: Hold Bank Rate.**

**Bias: Neutral.**

### The European ‘Monetary Illusion’

The recent European Union (EU) summit on the Euro-zone’s problems changed nothing. It merely reinstated the Stability and Growth Pact, with new pious intentions and unenforceable ‘penalties’. Looking back over the period since the Euro was introduced in 1999, it is clear that the great ‘benefit’ to the southern European countries of joining the Euro – i.e. German-style low interest rates, which enabled much less to be spent on servicing huge sovereign debts – was illusory. The illusion was that somehow the Euro-zone was more than the sum of its parts and that the implied solidarity would create a *de facto* bail-out for any country in trouble. Hence, the continued existence of Germanic interest rates for these countries for a decade.

### Struggle to maintain political legitimacy

It took the banking crisis to destroy the illusion, forcing Germany to protect itself against these implicit demands. Now, interest rates on the sovereign members of the Euro-zone reflect their true sovereign risk. The problem for each

sovereign country is, however, that it cannot control either its currency's value or the rate at which it prints money and inflates. These controls are available only if your currency is floating on the exchanges. So what exactly are the benefits of being part of the Euro-zone? Currently, there is only the cost of being unable to run your economy according to your own needs as the business cycle fluctuates. This cost-benefit logic is likely to become increasingly apparent to the citizens of all these southern countries as the grim austerity programmes mandated by the new Fiscal Agreement bite ever deeper. Their governments will struggle to maintain legitimacy as they implement these programmes; and leaving the Euro will rise up the political agenda.

**Many previous currency zones have broken up without excessive harm**

Some commentators – such as the former MPC member, Willem Buiter, who is now employed by Citigroup – have tried to frighten us with the stories of the disaster that will occur if the Euro-zone breaks up. Such tales have little credibility: currency zones have been breaking up for centuries with little more than temporary disruption. Most countries left gold in the 1930s, with beneficial effects as this enabled each country to pursue easier money. In 1870 the Latin Monetary Union (the first 'Euro-zone') broke up. The Soviet currency bloc broke up with the demise of the Soviet Union. The Asian Crisis of 1988 forced most Asian countries off their dollar pegs: these countries bounced back in the early 1990s.

**UK has been dragged down by weakness of the US economy, as well as Continental Europe's**

The UK economy will be adversely affected by the slow growth in the Euro-zone in prospect for 2012. This slow growth will continue until there is some certainty about which countries will stay in. However, this will not arrive until, perhaps, 2013 as the European elite responsible for the Euro will not lightly let it break up. The dissolution will be forced on it by messy national politics. However, a far more important external factor for the UK is the strength of the recovery of the US economy, which has been pallid and weak in job creation hitherto. Again politics is much of the reason. President Obama is unsupportive of the private sector and the market economy. His measures – not least 'Obamacare' but also his encouragement of union power – are proving toxic to private investment plans. Another factor is the stand-off in Congress over how to reduce the US budget deficit. Nevertheless, these issues will be resolved by the November 2012 Presidential election and the US should then start to come out of its torpor. It never pays to underestimate the resilience of the US economy.

**Slower growth in emerging markets has eased upwards pressure on commodity prices**

During 2011, the emerging market countries have had to tighten their monetary policies to combat inflation. This has led to a deceleration of their recent fast growth. Instead of world growth of around the 4% mark in 2011, it now will probably turn out closer to 3%. However, this deceleration has eased up the supply situation in commodities and oil so that their prices have come off their peaks. Meanwhile, technology has been devoted to reducing the world's dependence on them.

**Slower growth worldwide, but UK is starting to confront its supply-side weakness**

Overall, 2012 looks like being a year of slow growth worldwide, again a bit over the 3% mark. But this will not be a bad thing: it will allow inflation to subside in the emerging market countries and it will allow the balance of commodity net supply to be restored. The world trading system has held up, which is probably the most important development. It was the spread of protectionism in the 1930s that helped create the Great Depression. Against this background, the prospects for the UK are for more slow growth. However, this will not be a bad thing if this background leads to good supply-side policies, as there are signs it may. We have seen the public sector being brought back under control, with the dispute over public pensions now resolved and agreement reached on substantial cuts in public sector wage costs overall. There is a grittier realism around over education and the NHS. The UK private sector has been through a revolution in its practices since 1979. We now may be seeing the public sector being brought finally into that revolution.



### Economic dangers arising from ill-thought out banking legislation

The one area where a lack of logic prevails is over banking. Popular outrage at bankers has spilled over into a badly thought out plan for splitting the banks into retail and investment bodies. This will raise costs without reducing the probability of future crises. Whether split or not, the banking and financial system is tied irretrievably into a complex inter nexus, which is what forces the need for fire fighting by the Bank of England and the Treasury. The right way to limit banking risk is that of the latest Basel agreement – under which banks must post higher capital matching their risk profile. This will happen here too. However, the Vickers Report demands absurdly high posting compared with Basel III, whose requirements were already upped from Basel II. Fortunately, the government have gauged correctly the need to centralise these crisis and stability functions in the Bank where they always and rightfully belonged until Mr Brown created his Tripartite system that functioned so badly in the banking crisis. This UK repression of banking serves the economy ill and is one cause of slow growth in productivity. This is a major industry, after all, and also a key input into the rest of our economy.

### Financial repression

Finally, what of monetary policy? The Bank has taken serious risks with its credibility in allowing inflation to rise to over 5%. It may get away with it and inflation looks likely to fall back – though not as much as the Bank optimistically once again forecasts. Essentially, the ongoing banking crisis, now reignited by the Euro-zone crisis, has kept monetary conditions tight for those small business and personal borrowers dependent on the banks. The government has been able to dispose of all or most of its debt issue to the Bank through QE; the counterpart money created has simply been re-deposited in the Bank of England by commercial banks nervous of aggressive lending. Thus, financial repression is effectively limiting credit to the private sector while keeping the cost of public finance as low as possible. If it is assumed that all the debt in 2011-12 is soaked up by QE, as it was in 2010-11, the reduction in public debt held outside the banking system is over 20% of GDP. Thus the repression of banking is contributing tax revenue of some 0.6% of GDP (20% times 3% interest saved) on top of the direct bank levy.

### Euro-zone crisis likely to persist for foreseeable future

The Euro-zone crisis is likely to continue for the foreseeable future and most European banks are hardly able to borrow from the world wholesale money markets – US banks, for example, have reduced greatly their lending to them. As a result, they have borrowed recently nearly 500 billion Euros from the ECB. With this monetary tightness added to the effects of financial repression, there is no scope for any UK tightening moves at present. The return to a more normal monetary policy must await the ending of the Euro's crisis and the release of the banking system from its regulatory reign of terror. The corresponding vote is for no change in interest rates, with no bias. Liquidity injections and possibly QE may be needed to protect UK banks against the banking spill-over consequences from the Euro's crisis.

### Comment by David B Smith

**(University of Derby and Beacon Economic Forecasting)**

**Vote: Hold Bank Rate.**

**Bias: To hold Bank Rate, until the Euro-zone situation clarifies; keep more QE on standby for lender of last resort purposes.**

### Revised data indicate a worse balance of payments and tighter output gap last year

Britain's Office for National Statistics (ONS) released a mass of new data dealing with the national accounts, balance of payments, and government accounts on 22<sup>nd</sup> December with significant revisions back to 2010 Q1. The subsequent Christmas and New Year holiday break that followed immediately afterwards – together with the simplistic way the media report data – means that this new information has not yet been absorbed into the UK economic debate. One striking change is that the deficit on the current account balance of payments deficit looks as if it will have been at least £20bn higher last year than is suggested by the December 2011 consensus forecast compiled by HM

Treasury, which shows a deficit of £18.4bn. The other thing that commentators appear to have missed is that the cumulative effect of the revisions has been to revise the volume of non-oil GDP in 2011 Q3 upwards by 0.6%. This suggests that there was somewhat less of a negative output gap – for those, such as the Bank of England and OBR, who have such concepts at the heart of their forecasting frameworks – than was believed previously.

### The pre-Christmas UK official data releases

The other important aspect of the new ONS data is that the official statisticians have, at long last, published a back run of the new volume data for the national accounts back to 1955 Q1. This represents the first time these figures have been available since the switchover from the old 2006-based ESA 1995 national accounts to the new and noticeably different 2008-chained ESA 2010 figures on 5<sup>th</sup> October 2011. The belated provision of this data should allow economic forecasters, including those working in the Bank and the OBR, to start re-building their statistical models using the new ONS figures. However, the ONS data bank remains a nightmare to use and some crucial series still do not appear to be available before 1995 Q1 or later. Furthermore, the individual ONS statisticians appear to have been allowed to set up their historic data in their own way. This means that there is little consistency and some series are far harder to download than others.

### Wooden spoon of the year awarded to UK Office for National Statistics

In a year, in which the Euro-zone's political class have failed totally to respond adequately to unfolding events, the official UK borrowing forecasts had to be increased massively between the March and November 2011 OBR reports, and financial regulators threatened to bring about a new collapse in the supplies of money and credit through misguided pro-cyclical regulation, the competition for the wooden spoon award for the most outstanding piece of official economic incompetence during the course of 2011 has been unusually intense. However, and after due consideration, it seems appropriate to award it to the ONS for their decision to cease publication of all their established reports in August 2011, the closure of their old and clumsy – but functioning – data bank, its replacement by a series of balkanised excel spreadsheets, and the fact that having switched the national accounts to the new ESA 2010 basis, the relevant figures were not available until late December 2011, almost six months later than has been the case in the past. This has meant that, at a time of maximum economic uncertainty, it has been almost impossible to model or forecast the UK economy in the normal way for a period of several quarters.

### Political and data uncertainties

Looking ahead to 2012, there are two obvious sources of uncertainty. One is the late Harold MacMillan's "events, dear boy, events" when asked what really worried him as Prime Minister. This includes the possibility of political turmoil in the Middle East or a major US confrontation with Iran causing a major shock to the world's oil supply as well as the problems of the Euro-zone, and the political uncertainties associated with the forthcoming French and US Presidential elections, which could lead to different policies being adopted in both countries. The other major uncertainty, already been discussed, is the poor quality of the UK economic statistics which make it more difficult to apply objective forecasting methods than at any time for the past few decades.

### Is the problem deficient demand, or a supply withdrawal?

However, another major unknown concerns the extent to which the current weakness of the UK economy – together with that of many other Western nations – reflects a supply withdrawal and how far it reflects a Keynesian demand deficiency. There is widespread evidence from panel data studies that adding 1 percentage point to the share of GDP absorbed by government consumption and welfare payments slows the sustainable growth of GDP per head by some 0.1 to 0.2 percentage points per annum. This does not seem a powerful effect from a superficial viewpoint. However, it becomes highly significant once it is realised that the state spending share rose by 14.1 percentage points in Britain between 2000 and 2010, by 8.6 percentage points in the US and by 5.8 percentage points in the OECD area as a whole. The

negative effect of high public expenditure on growth revealed by panel data studies is a long-term relationship and one might expect the government spending ratio to rise in a recession. However, the average UK spending ratio between the two five-year periods 1996/2000 and 2006/2010 – a comparison that smoothes out the business cycle – still showed a rise of 8 percentage points, from 39.5% to 47.5%. This might be expected to slow the sustainable growth rate of real GDP per head by around 1 to 1½ percentage points.

**New output trend may be as much as 13½% down on the pre-crash one**

In the post-neo-classical endogenous growth models widely employed in international growth studies, the effects of a large increase in the ratio of government consumption to national output would be expected to have two distinct effects. The first would be to produce a downwards shift in the sustainable level of national output, the second would be to induce a slower rate of growth. The 22<sup>nd</sup> December ONS figures for the volume of UK non-oil GDP back to 2005 Q1 allows some rough-and-ready calculations of the potential size of this effect. This has been done by statistically relating the logarithm of real non-oil GDP to two time trends; one fitted from 1995 Q1 to 2007 Q2 and the other from 2009 Q2 to 2011 Q3. Real non-oil GDP was 13.7% below the pre-2007 Q2 trend in the third quarter of 2011 but it was only 0.3% below the post 2009 Q2 trend. Furthermore, the slope of the pre-2007 Q2 trend was equivalent to a growth rate of 3¼% each year while the post 2009 Q2 trend was 2% each year, representing a growth deceleration of 1¼ percentage points. The small number of observations for the two periods means that the difference between the two trends represents only a crude order of magnitude. However, the scale of the difference by 2011 Q3 explains why there is so much uncertainty attached to measures of the output gap, and why supply shocks can be extremely important, even if there may be many other factors involved in addition.

**Some very ‘dodgy’ New Year forecasts**

The massive data problems already alluded to and the fact that there has not been time to rebuild the Beacon Economic Forecasting model from scratch using the new ONS data – a process that normally involves five or six weeks of data compilation and re-estimation – means that any New Year forecasts are now highly uncertain for purely technical reasons, in addition to the risks arising from MacMillan’s ‘events’. However, neither ‘chickening out’ of making any predictions nor hugging the consensus represent worthwhile activities. On the basis of the data for the first three quarters, it looks as if UK real GDP increased by an average of 0.9% last year. For what it is worth, the market-price measure of real GDP is then expected to expand by a relatively optimistic 1.7% this year – the consensus growth forecast is 0.6% for 2012 – 2.8% in 2013 and 2.4% in 2014. The annual increase in the CPI inflation measure is expected to ease from the 4.8% recorded in November 2011 to 2.3% in the final quarter of this year, and stick there in 2013 Q4, but rise to 3.3% in 2014 Q4. The official Bank Rate is presently almost irrelevant where the structure of money-market rates that determine wider borrowing costs is concerned. Bank Rate is expected to remain at ½% until the middle of this year before rising to average 0.9% in 2012 Q4, and some 2.5% to 2¾% in late 2013 and throughout 2014. The current account balance of payments deficit appears to have been around £41.6bn last year. This imbalance is forecast to be £43.4bn this year, £51.5bn next year, and £55.2bn in 2014. The Public Sector Net Borrowing measure of the UK budget deficit is predicted to be £130.3bn in fiscal 2011-12, £139.8bn in 2012-13 and £132.7bn in 2013-14, after which it should be on a much clearer downwards trend, however. Finally, claimant-count unemployment is expected to rise from the 1,598,400 reported for November 2011 to 1,691,000 in the fourth quarter of this year, but ease to 1,673,000 late next year, and 1,621,000 in the end quarter of 2014. If an economic ‘gold medal’ should be awarded for such a lack lustre year as 2011, it should probably go to ordinary private-sector employees and their bosses whose mature co-operation in accepting substantial cut backs in real take home pay, in return for maintaining employment, has helped to prevent the huge surges in joblessness observed in the downturns of the early 1980s and the early 1990s.

### Monetary policy and macro-prudential regulation

As far as UK monetary policy is concerned, the latest figures show that the annual growth of the preferred M4<sup>ex</sup> broad money definition was 2.6% in the year to November 2011 while retail deposits and cash (M2) increased by 2.9%. These are not exactly 'boom-boom Britain' figures but they do not suggest a US 1930s style banking-sector meltdown either. The main risk now is that misguided financial regulation leads to a fall in commercial bank lending to the private sector and the broad money stock. The Bank of England published an important discussion paper on 20<sup>th</sup> December, *Instruments of Macro-prudential Policy*, which will need to be studied carefully before commenting further. The general issues of principle involved are that: first, the regulatory authorities should always bear in mind the macroeconomic consequences of the re-organisation of commercial-bank balance sheets induced by financial regulation; and, second, the regulatory and monetary officials concerned do not work at cross purposes, something that is supposed to be ensured by common members of the Financial Policy Committee (FPC) and the MPC. As far as the 12<sup>th</sup> January rate decision specifically is concerned, the international and domestic and international uncertainties are such that another hold appears to be the 'least-bad' decision.

#### Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

**Vote: Hold Bank Rate.**

**Bias: To tighten, unless inflation eases sharply.**

### Euro-zone crisis has not been resolved

The Euro-zone crisis has not been resolved. The meeting of the EU leaders in December 2011 did not accomplish a breakthrough. They simply agreed to take the rules, which they had ignored in the past, more seriously in the future. Furthermore, the details of what they agreed, has not been worked out yet. It is even unclear at the moment whether the new agreement will be part of a new Treaty or not. This increases uncertainty about economic policy in the Euro-zone. Until this uncertainty is partially or fully resolved, the recovery in the Euro-zone will be fragile. This will slow down the recovery of the British economy.

### UK inflation is a serious cause for concern

Inflation is a serious concern. The annualized monthly inflation measured with the CPI was 4.8% in November, and it has been above 4% in every month since the beginning of 2011. We can get a better idea about inflation dynamics if we calculate a three-month moving average. Nine out of the twelve CPI categories had higher annualized monthly inflation in November 2011 than they had a year earlier. Inflation shows no signs of slowing down at the more disaggregated level. Inflation of alcohol, household equipments, transport and housing (including water and fuel) all accelerated by more than 2 percentage points between November 2010 and last November. The longer the current pattern prevails the more likely it is that inflationary expectations will lose their anchor.

### Wait and see in the short term but raise rates if inflation does not fall

Given the uncertainty in the Euro-zone a 'wait-and-see' approach is appropriate at the moment despite the inflationary pressure in the British economy. Bank Rate should be held in January. However, I would signal tightening. If there are no clear signs of easing inflationary pressure in the near future, a rise in Bank Rate could be necessary.

#### Comment by Peter Warburton

(Economic Perspectives Ltd)

**Vote: Hold Bank Rate; no extension of QE; reinstate Special Liquidity Scheme.**

**Bias: Raise Bank Rate.**

### UK monetary policy overshadowed by Euro crisis

Discussions regarding UK monetary policy have been overshadowed by developments in the Euro area. The Bank of England has adopted a fearful attitude towards the European banking threat which has sent ripples of despair throughout the economy. This is a counterproductive stance and one which is unjustified by the nature of the threat. The disintegration of the Euro remains a highly improbable outcome until the mechanisms and protocols for orderly

departure from the Euro area have been devised and formally approved. Disorderly exit of Greece, or of any other country, would carry grave consequences for French and German banks through their colossal exposures to interest rate swap contracts. It is a reasonable assumption that the Euro area nations will not embark on a path of mutually assured destruction.

#### **Preparing for Euro-zone disintegration**

The best preparation for the eventuality of Euro disintegration is for the UK authorities to grant maximum flexibility of response to households, businesses and financial institutions. For households, the priority is to regenerate private sector employment growth through tax reform. For businesses, it is to press ahead urgently with the de-regulation of the UK economy. For banks, it is to undergird their operations through structural, un-stigmatised, liquidity support.

#### **Brutal withdrawal of Bank of England's Special Liquidity Scheme**

Over the past fifteen to eighteen months, UK residential construction activity and housing market turnover were among the biggest casualties of the Bank of England's misguided urgency in withdrawing its emergency liquidity support from the banking system. As a result the UK banks' customer funding gap, effectively its dependence on wholesale funds, has reduced from around £900bn at end-2008 to £275bn at end-June 2011. The banks have survived the brutal pace of withdrawal of the Special Liquidity Scheme only through a combination of deposit growth, loan shrinkage and new capital issuance. The forced contraction of bank lending to the private sector has superseded all other policies and initiatives, including the ½% Bank Rate and Project Merlin. Although this phase of contraction is drawing to a close, banks must accomplish £140bn of term refinancing in 2012, front-loaded to the first half of the year, and may struggle to do so in the context of Euro area banking woes. There is a strong case for the reintroduction of the Special Liquidity Scheme, to enable bank credit to flow more readily to the private sector after a year of enforced drought.

#### **Consumer sentiment is back in the doldrums but the end is in sight**

Consumer sentiment is back in the doldrums after a second successive year of real after-tax income compression. However, the end is in sight. The referred pain from the GDP slump in 2009 is working its way through the economy and 2012 should begin to see a remission. Affordability measures for first-time buyers have moved into attractive territory but the interest penalty associated with 90% loan-to-value mortgages remains a heavy disincentive. The scope for a fundamental improvement in housing market turnover arising from first-time buyers rests, to a significant extent, on the successful take-up of the new government scheme to support house builders, taking effect in the spring of 2012.

#### **Housing sector prospects and Bank Rate**

The recovery of the housing sector both in terms of residential construction and housing transactions remains an important barometer of the wider economy. After the largely self-inflicted setbacks of the past year or so, there are reasonable grounds for supposing that housing-related activity will stage a comeback in the context of cheap credit, more supportive government policies and yield-starved investors. The best hope for a resumption of economic recovery in 2012 lies in the removal of the constraints to bank lending growth to interest-rate sensitive sectors. This is not the moment to raise Bank Rate, although the reconnection of Bank Rate with the market interest rate structure cannot be postponed indefinitely. The Bank's programme of gilt purchase appears to be suffering from the law of diminishing returns and should not be extended in its current form.



## **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 (Deloitte and 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), Gordon Pepper (Lombard Street Research and Cass Business School), 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 TSB Corporate Markets). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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