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Shadow Monetary Policy Committee

June 2013

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IEA's Shadow Monetary Policy Committee votes by five to four to raise Bank Rate by ¼% in June

In its most recent e-mail poll, which was finalised on 29th May, the Shadow Monetary Policy Committee (SMPC) decided by five votes to four that Bank Rate should be raised on Thursday 6th June. Four SMPC members wanted an immediate increase of ½%, while one advocated a rise of ¼%. Such a split vote for a rate hike would imply a rise of ¼% on normal Bank of England voting procedures. However, a substantial minority of four SMPC members believed that economic activity in Britain – and also in some of its main trading partners – remained so weak that Bank Rate should be held at its present ½% for the time being. Almost irrespective of their precise views on rates, most members of the shadow committee saw no immediate justification for adding to the existing stock of Quantitative Easing (QE). However, one wanted to start on the process of reversing it.

One reason why a narrow majority of the SMPC wanted to raise Bank Rate in June was the belief that lending costs would have to be normalised at some point. It was less disruptive to make the necessary rate hikes early and in 'baby steps' than to leave it too late and then have to make an abrupt upwards move; perhaps, because the financial markets had lost faith in the resolve of the British authorities. There remained widespread concern that excessive financial regulation was impeding credit creation to the private sector. Nevertheless, UK broad money growth had now recovered sufficiently to sustain a non-inflationary recovery, given the slow growth of productive potential. The economic situation was unusually opaque at present because a major re-working of the UK national accounts would be published on 27th June. This could lead to substantial revisions to current growth figures.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 19th July and its minutes will be published on Sunday 28th July. The next two SMPC e-mail polls will be released on the Sundays of 30th June and 1st September, respectively.

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Comment by Tim Congdon

(International Monetary Research Ltd)
Vote: Hold Bank Rate; no change in asset purchases.
Bias: Hold Bank Rate for next three months and use rate setting and QE to achieve growth in broad money of 3% to 5%.

Regulatory blight on money creation process

The regulatory blight on banking systems continues in all of the world's so-called 'advanced' economies, which means for these purposes all nations that belong to the Bank for International Settlements (BIS). The growth of commercial banks' risk assets is constrained by official demands for more capital relative to assets, for more liquid and low-risk assets in asset totals, and for less reliance on supposedly unstable funding (i.e., wholesale/inter-bank funding). If nothing else were happening, the contraction of asset totals and the rise in the proportion of capital to total liabilities would result in falls in the quantity of money, broadly-defined, which would in turn imply falls in the equilibrium levels of national income and wealth. In some of the Eurozone's Club Med countries, and even to some degree in France and Italy, these processes of money contraction are still very much at work, and macroeconomic outcomes are weak and disappointing. Indeed, for the Eurozone as a whole output is flat and unemployment is rising.

Banks are substituting 'safe' assets for lending

In virtually all the advanced economies the ratio of safe assets (i.e., cash and government securities) to banks' total assets is rising. The importance of new credit extension to banks' business activities has declined, despite constant laments in the media about the absence of new bank lending to such allegedly deserving causes as small business and first-time home buyers. Senior policy-makers seem not to understand the connection between the regulatory zeal 'to tidy up bank balance sheets' and the marked reluctance of banks to grow their businesses. In the UK, this has led to obvious, indeed ludicrous policy inconsistencies. It was the same Chancellor of the Exchequer (George Osborne) who endorsed the regulatory excesses of the Vickers Report in 2011 that announced the Help-to-Buy initiative to boost mortgage lending in the 2013 Budget. The Chancellor's "left hand taketh away and the right hand giveth back". Both the taking-away and the giving-back occurred at the same time and were blessed by the same government.

QE has helped to offset adverse regulatory shocks

The situation is redeemed to some extent by the widespread adoption of so-called QE, which can be regarded as the deliberate creation of money by the state. (A multiplicity of definitions is possible, because the subject is intellectually a total mess.) Because the banks' safe assets are growing as a result of QE, the quantity of money is in fact rising slightly – typically at annual rates in the low single digits – in most of the leading countries, including the UK. In association with virtually zero interest rates, low but positive money growth has been accompanied over the last year by asset price buoyancy, with rising stock markets, very low bond yields, and steady markets in residential and commercial property. While the global upturn is being led by the USA, macroeconomic conditions in the UK have been satisfactory. Better growth is also being seen in Japan where an aggressive monetary stimulus is currently intended by the new Abe government. It is only in the Eurozone, where QE operations are hampered by the multi-government, hydra-headed monster that is the single currency area, where monetary conditions remain persistently hostile to growth.

UK monetary growth

In the UK the M4^{ex} measure of money increased by 4.5% in the year to March, while the stock of M4^{ex} lending (i.e., bank lending to the non-bank private sector, excluding that to intermediate other financial corporations) fell by 0.1% while the stock of M4 lending as a whole was down by 1.9%. In other words, money growth has been positive only because other forces have offset the contractive effect of reduction in bank claims on the private sector. QE has undoubtedly been the dominant such force.

UK recovery is under way but there is little imminent risk of overheating

Although recovery is certainly under way in the UK, it is wholly inappropriate for commentators to start worrying about overheating in labour and product markets. In fact, the latest figures for consumer price index (CPI) inflation were better than expected and almost back down to the 2% official target. The news from the labour market varies from month to month, but the most recent numbers – which may be erratic – have indicated *rising* unemployment. I am in favour of no change in sterling interest rates and the continuation of QE at a sufficiently high level to ensure that broad money growth (on the M4^{ex} measures) runs at an annual rate of between 3% and 5%. My bias – at least for the next three months – is for 'no change'. It is plausible that I will be advocating higher interest rates in 2014. However, much depends on a realisation in official quarters that overregulation of the banks is, almost everywhere in the advanced world, the dominant explanation for the sluggishness of money supply growth and, hence, the key factor holding back a stronger recovery.

Comment by Anthony J Evans

(ESCP Europe Business School)
Vote: Raise Bank Rate by ½%.
Bias: Hold QE.

Discretionary monetary policy has failed

May 2013 saw a slight fall in the rate of consumer price inflation (from 2.8% to 2.4%) and, whilst it is true that the twelve-month rate for CPI has been reasonably stable, it is consistently high. In an inflation targeting regime, this needs to be confronted because the longer inflation remains above target the more fanciful are claims that it is temporary. The introduction of forward guidance institutionalises the Monetary Policy Committee's (MPC's) leeway but at the cost of instilling even greater discretion. The fact that monetary policy since 2007 has been characterised by greater discretion, rather than better rules, is a large part of why it is failing.

Demand side problems may have eased but supply ones remain

Current events exemplify one of the main failures of inflation targeting – the inability to distinguish between price changes caused by changes in the demand to hold money, and price changes due to changes in productive efficiency. For some time, the inflation target has served as a counterproductive anchor that has prevented monetary easing from occurring when needed. However, just because monetary easing would have produced a stronger recovery if employed sooner, does not mean that more monetary easing now can compensate. It seems increasingly clear that with real growth below trend and CPI above target that a large part of the UK's difficulties fall on the supply side. The fact that there was a demand problem in the past does not mean that there still is one today.

Nominal GDP growth adequate to sustain recovery

The 2013 Q1 growth rate of Nominal GDP (NGDP) was 3.4% higher than the same quarter of 2012, which is more than double what it was for 2012 Q4. For most of 2012 it seemed that NGDP had fallen to a sub 2% annual growth rate but the fact that it is

increasing implies monetary policy is loose. For those who treat 5% NGDP growth as the norm this remains too low, especially if the goal is to catch up to the previous trend. For those who think the previous trend was inflationary, even looser policy would be a concern.

Dangers of ad hoc schemes to stimulate lending

Ad hoc schemes that intend to compensate for blockages in the credit channel bring with them real dangers. The Funding for Lending scheme (FLS) has the potential to encourage banks to lend more but it should be highly concerning when the central bank simultaneously sets wholesale funding costs, and directs the flow of credit. There is no basis to believe that officials possess the knowledge required to manage this policy in a socially desirable way. There is already a concern that zero lower bound policy has generated new bubbles, and the Bank of England should be wary of stoking new ones (or indeed perpetuating existing ones). Emphasis should be on regulatory reforms that allow banks to serve as financial intermediaries. Credit needs to flow to entrepreneurs because they are in the best place to invest in value-generating projects, not because increases in credit are good per se. Lower taxes, fewer regulations, less uncertainty etc. play a bigger role than 'lack of credit'. If anything, the misallocated credit from the preceding boom has yet to be properly reallocated. This is a prerequisite for a healthy and sustainable economic recovery.

Balancing the monetary risks

The annual growth of $M4^{ex}$ continues to run at a stable rate and the MPC should carefully balance the risks of loose monetary policy on the one hand, and tightening too quickly on the other. A modest increase in interest rates would restore some credibility to the MPC, but ideally it would be accompanied by clear guidelines on the expected path of both inflation and real output growth. The fact that NGDP growth has jumped up, together with looser policy globally (for example, in Japan) means a ½% rise could be warranted. To be clear, raising interest rates does not necessarily mean a desire for 'tight' money. Rather, a 1% Bank Rate would be 'less loose' and help us infer what level it should be in order to be neutral.

Comment by John Greenwood

(Invesco Asset Management)
Vote: Hold Bank Rate; maintain asset purchases at £375bn.
Bias: Employ rate changes and QE to keep $M4^{ex}$ growth at 4% to 6%.

Weak external demand is spoiling the recovery

The slow recovery of the British economy continued in 2013 Q1, and the available data suggests this pattern extended into the second quarter. The economy is likely to remain in this gradual, but fragile, improvement mode for the remainder of the year. Progress on the domestic side is being counterbalanced by difficulties on the external side. This is well illustrated by the 1.3% growth of real domestic demand over the year to 2013 Q1, which contrasts with the growth of 0.6% in real GDP over the same period. The difference was due to net trade – mainly the weakness of UK exports to the Eurozone – where the recession shows no sign of abating.

Service sector recovery offset by weak manufacturing and construction

Viewed from the production side, the steady recovery of the service sector is being offset by declines in the manufacturing and construction sectors. Since the recovery started in mid-2009, services have grown fairly consistently at 0.9% p.a. while manufacturing and construction both surged initially in 2009 and 2010, but both have been declining since 2011, reflecting mainly international factors. However, new construction orders improved in the second half of 2012, suggesting a slightly better outlook for this sector in 2013.

Three headwinds to recovery

In order to see significant progress towards a sustainable recovery at close to historical growth rates, the economy will need to overcome three main headwinds: the continuing weakness of balance sheets in the banking and household sectors; the tendency over the past year or two for inflation to exceed personal income growth, thus eroding purchasing power in the crucial consumer sector; and the weakness of economic activity abroad, particularly in the Eurozone, our largest trading partner.

Balance sheet repair faster in US than in Britain

In the area of balance sheet repair, Britain is making much slower progress than the US, mainly due to the more comprehensive or systemic measures taken by the US authorities to recapitalise American banks and detoxify their loan books in the early stages of the recession. As a result, US bank lending has been growing at about 4% per annum since March 2011 while UK bank lending has yet to start growing again. Household balance sheet repair is progressing roughly at the same pace in both economies, and seems likely to require two or three more years before completion. The reason is that, unlike companies, households cannot either raise capital or easily dispose of assets in order to repay existing debt. Confirming this, survey data quoted in the Bank of England's *Inflation Report* shows that the most indebted households have raised their savings rate (and cut consumption) the most.

Good news on inflation

On the inflation front, the news has recently been better, with the April CPI slowing to 2.4% year-on-year. However, with administered price increases still to feed through to the CPI and energy prices subject to further hikes, progress in bringing down inflation may be slow for the remainder of 2013. Over a longer term horizon, a combination of subdued $M4^{ex}$ growth and weak domestic demand imply it is likely that the inflation target will be undershot in 2014. This should create space for higher employment and steady wage growth to generate stronger growth in real spending, as well as encourage firms to increase output.

External drag on UK growth

On the external side, despite the easing in financial symptoms of the Eurozone crisis, the economic performance of the Euro-area has weakened with recessions in both the periphery and the core. When added to the sub-par growth of the US economy, and the slowdowns in China, India and Brazil, it is no surprise that demand for British exports remains weak. This in turn implies a longer period will be needed to rebalance the UK economy away from consumption and housing towards exports and business investment.

Delay rate increase until recovery is more advanced

In this environment, the Bank should hold rates stable at ½%, but be prepared to undertake additional asset purchases if monetary growth plunges again, or the Eurozone crisis flares up once more. Rate increases at this stage would damage the prospects for economic recovery, and should be delayed until the recovery is substantially more secure.

Comment by Graeme Leach

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

Four headwinds impeding recovery

Over recent years, the UK economy has experienced an 'L' shaped economic recovery. The weak recovery has arisen because of four main headwinds. The first has been the need for deleveraging in both the public and private sectors. The second has been the damage done to the banking system as a result of the financial crisis

and the impaired monetary transmission mechanism. Third has been the squeeze on household incomes from inflation running well ahead of earnings growth. Finally, there has been the impact on precautionary behaviour, by both companies and consumers, from the ever present Euro crisis. To a varying extent, and at different times, these headwinds have combined to hold back recovery.

Rise in government intervention means that the UK faces a poor output/inflation mix

However, in late 2012 and early 2013 the economy also acquired a strengthening following wind, with the pick-up in the rate of $M4^{ex}$ broad money supply growth to around 4% to 5% on a year on year basis in recent months. Whilst such rates of growth still imply a recovery which is more 'L' than 'V' shaped, they do nonetheless suggest that GDP growth in 2013 could be around 1.5%. The underlying rate of growth in potential output in the UK has probably slipped to under 2%, because of the growth in the total intervention index – i.e., the combined burden of public spending, taxation and red tape. Supply-side weakness suggests that any improvement in nominal GDP growth – arising from the acceleration in broad money – will be split unfavourably towards inflation as opposed to real GDP growth. Consequently, inflation may struggle to fall back towards target in 2014 despite a continued output gap.

Comment by Andrew Lilico

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

Misguided policy debates

Much is made in the media of the debate amongst economists between the majority favouring spending and deficit cuts or believing them necessary if undesirable, and a vocal minority that favour increasing the deficit at least in the short-term. What has gone largely unremarked is the important debate between the majority view that interest rates must continue at around zero – perhaps, accompanied by even more QE - and the minority view that rates should be raised. In my own case, the belief that rates should be increased rests on the propositions that follow.

The long-term growth rate has fallen sharply and UK banks look shaky again

First, the fundamental challenge confronting the UK economy is not just a few quarters of below-trend growth. The fundamental challenge is that the underlying sustainable growth rate of the economy has dropped from the norm of 2.5% or higher of the 1980s and 1990s to perhaps as low as 1% today. If that underlying growth rate cannot be raised, then UK households and businesses that took on high debts during the 2000s will default on those debts unless there is high inflation, bankrupting our banks. The recent problems of the Co-op bank confirm that the UK banking sector's problems are by no means over. If the UK's nationalised and quasi-nationalised banks become distressed again, then the UK government that stands behind them will face the choice of either allowing them to default or bailing them out. Either option will impact on the UK government's perceived credit-worthiness. If markets lost confidence in UK government debt, bond yields might rise, reducing the value of the Bank of England's QE-acquired bonds. This capital loss would impose large further costs on the Treasury, and also reduce the value of the UK government bonds held by UK banks, placing them into further distress. That vicious cycle can only be broken by either raising the sustainable growth rate of the economy or by a period of high inflation.

Loose policy cannot raise long-run growth

Second, the central lesson of macroeconomics of the past forty years is that loose fiscal and monetary policy cannot raise the medium-term sustainable growth rate of the economy, but can reduce it if done to excess. It is, therefore, both futile to imagine

that keeping interest rates at zero and printing money can address our core sustainable growth problem, unless the intention is to deliver high inflation, and dangerous to attempt to do so – since such an attempt could reduce the sustainable growth rate further, making things worse not better. Given that the sustainable growth rate is so low, any short-term boost to output that is achieved by such loose policy can only come at the expense of inflation and fall-back into recession. We saw in 2008 and 2011 that inflation rises to 5% and upwards when the UK economy is not actually contracting.

Loose monetary policy has 'shot its bolt'

Third, more than four years into zero interest rates and QE, monetary policy has had its go. Monetary policy can be a powerful tool for boosting growth in the short term. However, the period over which it is efficacious is from around nine months to three years. Beyond that, very loose policy will tend to damage growth and also be morally questionable, as very low rates punish the prudent in order to protect the imprudent from the consequences of their errors. We cannot indefinitely accept that those that chose not to over-extend themselves in the 2000s should suffer, just so as to spare those that did over-extend themselves from the fruits of their folly.

Sustained abnormally low rates undermine confidence that recovery is possible

Fourth, very low rates and extra QE at this stage provide a negative signal – they tell the financial markets and economic agents in general that policymakers believe that the situation is dire and recovery is still far off. We are well past the point at which they were signalling that the problem was temporary and policy could and would be used to turn things around quickly (the more normal signal provided by policy loosening). Raising rates would be a sign that there is a future of normality awaiting us, and with baby steps we can get there. The first of those baby steps should be a modest rise in rates. I would start with ½%.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind QE.

The new Governor has a chance to improve present policy disarray

Mark Carney arrives as the new Governor of the Bank at a time when policy is in disarray but at the same time all the levers of policy are in the Bank's hands. He has a good chance to improve matters. What is the problem? The Bank is pursuing a monetary policy that is at its loosest for all time. Via QE the monetary base has expanded to nearly eight times its 2007 value. Virtually all that expansion is sitting in bank reserves, as the extra money printed was deposited and not lent; so the banking system has created no additional money, and the total ('broad') money supply has barely grown. Meanwhile, interest rates on government three month bonds are held down close to the Bank Rate of ½%, an all-time low that has prevailed for four years; on longer maturities the government can borrow at rates below inflation. Yet, rates on credit to small businesses remain, as far as we can measure them, stratospheric; and lending to Small and Medium-sized Enterprises (SMEs) continues to contract sharply. The economy is growing weakly at best. Equity prices have soared as investors have chased yield elsewhere than in government bonds; yet large businesses refuse to invest, preferring to wait for recovery. As for inflation, it is now sagging back towards 2%, after a long period of being driven up by soaring commodity prices, now mercifully falling back; the lack of credit and money growth has held domestic inflation down so the Bank's credibility has not been tested.

Expansionary monetary policy has not stimulated activity

In a nutshell, this highly and indeed dangerously expansionary monetary policy has had little or no effect on credit, real activity, the broad money supply or inflation but has driven down yields on government bonds and other assets, damaging savers at the expense of government and large borrowers. Why?

A major reason is regulatory obstructions

What we have been discovering the hard way is that money does not course equally vigorously through all channels, especially when regulators insert large barriers between them via their controls. Small businesses always find it hard to get credit and face a rate much higher than Bank Rate, which varies with general business conditions in a way that we do not observe very well; arrangement and other fees come and go, as do eligibility criteria and collateral requirements. Now, in addition to the usual hurdles they would face because of poor business conditions and the banks' internal difficulties, these businesses face a new and massive regulatory obstruction: as they are 'high risk' they push up a bank's risk-weighted assets and so force the bank to get expensive extra capital to satisfy the new capital ratios. The banks have reacted by refusing to expand their balance sheets by lending to these expensive firms. Instead they have clung onto their 'low risk' large customers and official paper, most especially reserves with the Bank. The credit channel to the dynamic part of the economy, the 50% represented by SMEs, has been blocked by regulation. So all the money printed has gone into the other channels, causing a lake of liquidity to form around governments and large corporations. The economy has flat-lined as these monopolistic elements bask in the luxury of doing nothing much except 'cuts'.

Mr Carney needs to change current approach

Mr Carney should change this. As the chief regulator he should cut back these capital requirements, or at least postpone them *sine die*. As the banks come back to life, he can then junk the clumsy bureaucracy of the FLS and the mortgage subsidy for first time buyers. He will then need to tighten monetary policy as bank credit expands and the recovery strengthens. All those bank reserves created by QE are like dry firewood waiting for a spark; not merely must it be stopped as agreed by majority in the latest MPC minutes but it must also be removed fast. Interest rates must rise to keep credit and money growth under control. There will be difficulties in removing the existing stock of QE, as the Bank's bond holdings will fall sharply in value with rising interest rates; also politicians will want to stop the Bank 'spoiling the recovery'. However, the Treasury will have to absorb the loss on the Bank's assets (after all the Bank's loss is its gain) and the politicians must be ignored.

Regulation works against grain of a free market economy

For the longer term, people will worry that weakening bank regulation will lead to a future crisis. But regulation works against the grain of the free market economy; it would be better to control excess credit expansion by monetary policy in future. The inflation target should stay at 2% because as a society we decided to eliminate the deadly virus of unchecked and uncertain inflation. However, the monetary control mechanism could supplement the target with a money supply target which would proxy the otherwise unobservable cost of credit to SMEs. The setting of Bank Rate and the printing of money could be jointly orientated towards the control of monetary conditions. If Mr Carney can sort these things out, he will have more than earned his unprecedented Gubernatorial package.

QE should be reversed and bank regulation eased back sharply

What should be done this month? QE should start to be reversed and bank regulation eased back sharply. One interim solution would be to make any capital requirement smaller and also absolute – that is, related not to risky assets but merely to the overall size of the bank balance sheet. Then 'excess risk' when it eventually becomes a threat

in some years' time would be handled by making monetary conditions respond to the money supply. Meanwhile, the marginal cost penalty on bank lending to SMEs would be removed. Pending all these changes we need the FLS and the mortgage subsidy scheme to be expanded as necessary to offset the damaging effects of regulation-much as the government is now being forced to do; these actions will continue to bear down on the costs of credit to smaller borrowers. Interest rates on government paper should rise now by 0.5%, to begin the normalisation of the official paper market. Besides beginning to remove the distortion in the savings market, it would also revive the interbank market, whose operations are suppressed by the lake of QE reserves and the low rate on borrowing from the Bank. It will also take the froth off the equity market. Most importantly it will start to reduce the dangers of inflation as the economy re-enters growth.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)
Vote: Raise Bank Rate by ½%; hold QE.
Bias: Avoid regulatory shocks; break up and fully privatise state-dependent banking groups; raise Bank Rate, and maintain QE on standby.

Sir Mervyn King's departure

Sir Mervyn King has been such a predominant influence on the Bank of England's economic approach since he became its Chief Economist in 1991, Deputy Governor in 1997, and Governor in 2003 that the Bank's economists must be feeling a similar sense of disorientation to that felt by the state officials of Eastern Europe after the fall of the Berlin wall. This is not intended as a suggestion that Sir Mervyn was running a totalitarian system. Indeed, the openness and transparency of UK monetary policy making – as demonstrated at the question and answer session at Sir Mervyn King's final *Inflation Report* press conference, for example – is probably at the leading edge of central banking practice. However, the removal of such a powerful intellectual presence from any institution after more than two decades must inevitably give rise to a period of reflection and re-consideration. One over-arching concern about Sir Mervyn's period in office has been the apparent closeness of the Bank's approach to that of the US Federal Reserve, as against the traditional sound money commitment and long-term policy orientation of the pre-European Monetary Union (EMU) Bundesbank. There is a risk that, as a Canadian, the incoming Governor, Dr Mark Carney, will also adhere too closely to the excessively activist US approach to monetary policy, which led to serious over-steering and was a main cause of the Global Financial Crash. An interesting thought experiment is to ponder what would have happened to the credibility (and also the techniques) of UK monetary policy if an experienced ex-Bundesbank official (several of whom have chosen to leave the ECB in recent years) had been appointed as the new Governor by Mr Osborne.

New Bank of England forecasting model

In keeping with its commitment to transparency, the Bank of England publically released details of its new forecasting 'platform' on 24th May. This system has been used since the end of 2011 to generate the *Inflation Report* forecasts, although resource constraints at the Bank have meant that the documentation has only just been placed in the public domain. The term 'platform' has been used deliberately by Bank officials because there are four separate elements involved: COMPASS, which is the new central core model; MAPS, a macroeconomic modelling and projection toolkit; EASE, which is a user inter-face, and a suite of sub-models that are used to supplement and extend the projections generated in COMPASS. The new platform is

consciously designed round the institutional forecasting procedures of the MPC; in particular, the important role of pure judgement on the part of MPC members. As such, it guarantees forecasting consistency in a balance sheet sense but it may be too open a system to fully incorporate the feedbacks that once would have been considered desirable in a macroeconomic forecasting model. The documentation provided by the Bank falls not far short of two hundred pages, often containing some dense mathematics, and there has not been time to digest so much material properly.

Some concerns about the new Bank model

On the basis of a quick read through, a number of specific concerns are as follows. First, there is only a rudimentary representation of the government sector in COMPASS, despite the fact that general government expenditure accounted for 50.3% of UK non-oil basic price GDP last year. This means that the important feedbacks between monetary policy and the private-sector tax base, together with the independent effects of changes to individual spending items and tax rates on the targets of monetary policy, are not represented. Second, Britain is correctly modelled as an open economy. However, the UK model is not nested inside a global model, so it is difficult to represent consistently the indirect effects of, say, an oil price shock operating through international variables. Third, a relatively short data estimation period of 1992 to 2007 has been employed – the Bank explains the reasons for this choice – but it is easy to over-fit models using such short data runs, making them unreliable forecasters. A fourth concern is that the main monetary policy instrument incorporated in COMPASS is Bank Rate. Sub-models can be run in conjunction with COMPASS that allow credit shocks to be simulated, generally by increasing the wedge between borrowing costs and Bank Rate. However, it is not clear that this is enough to represent the effects of official balance sheet constraints and credit rationing on the economy, a subject that has been of major concern to the SMPC. It is also noteworthy that there is no necessity in COMPASS for the supply of money and the demand for money to be in equilibrium before the model settles down because the money supply itself does not seem to be included. This is consistent with the theoretical approach adopted by central banks in recent decades. However, central bankers have made an unholy mess of the world economy during this period – in large part, because they ignored what the ECB used to call the 'second monetary pillar'.

Both UK and OECD broad money growth are satisfactory

The latest figures for the $M4^{ex}$ definition of the UK broad money stock show a rise of 4.5% in the year to March, while broad money in the aggregate Organisation for Economic Co-operation and Development (OECD) area was 5.5% up on the year in the first quarter of 2013. The post-2008 crisis period of very weak monetary growth seems to have come to an end during the course of last year. Current monetary growth rates might be regarded as being appropriate on a medium-term perspective to achieve low and stable inflation given the rather subdued outlook for the growth of potential supply both internationally and in the UK. The main concern is that governments are hogging the money creation process and that both total bank credit creation and, within it, lending to the productive private sector are being crowded out, largely because of the financial repression caused by excessively onerous regulations. The only cure is for the financial supervisors to regulate more intelligently and less aggressively and for governments to improve fiscal discipline by means of better spending control.

Recent economic indicators

The drop in the annual CPI inflation rate from 2.8% in March to 2.4% in April was a pleasant surprise, which was reinforced by a drop in core producer price inflation from 1.3% to 0.8% between the same two months. However, annual house price inflation

on the ONS measure picked up from 1.9% to 2.7% between February and March, possibly as a reflection of the recently higher rate of $M4^{ex}$ increase as well as Mr Osborne's misguided schemes to ramp up the housing market. The ONS will be rebasing and redefining the UK national accounts on 27th June. Previous annual re-workings of the official GDP figures have sometimes introduced such radical back revisions that they have altered the tone of the entire economic debate. This means that there is probably little point in worrying too much about the finer details of the unrevised 0.3% increase in real GDP in the first quarter reported on 23rd May, which represented a 0.6% rise on 2012 Q1. The most recent labour market statistics have shown some signs of weakness, especially in annual earnings growth which was only 0.4% in the year to 2013 Q1 and zero in the private sector, and need to be watched carefully. Overall, however, a Bank Rate increase of ½% seems appropriate at the June MPC meeting – incidentally, this will be Sir Mervyn King's last rate decision before Dr Carney takes over – with no further increase in QE for the foreseeable future. British interest rates will have to be normalised at some point. A stability orientated monetary policy maker would recognise that it is less disruptive to start the process early, and in small steps, rather than leave it too late and then have to slam on the brakes.

Comment by Peter Warburton

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

Blockages in private sector credit transmission

It is testament to the strength of regulatory pressures on the banks that the annual pace of M4 lending, excluding intermediate other financial corporations, has fallen back from 1.7% in December 2011 to -0.1% in March 2013. Blockages in private sector credit transmission remain a formidable obstacle to UK economic recovery. The M4 money stock, with the same exclusions, has picked up some momentum over the same period to register annual growth approaching 5% on average over the three months to March. Plainly, it is the underfunding of public sector borrowing that separates the outcomes.

UK authorities' regulatory gold plating

The failure to stimulate additional lending, notwithstanding four years of ½% Bank Rate, £375bn of asset purchases and the FLS, illustrates the policy dilemma. The gold-plating of international bank regulation by the UK authorities has deprived the economy of valuable lending capacity at a time when public expenditure was in retreat, for very good reasons, and the Eurozone economies were in spasm.

But some signs of increased credit supply to business

Nevertheless, there are tentative signs that large companies have begun to increase their capital market borrowings. Private non-financial corporations borrowed £8.5bn in the first quarter of 2013 in the strongest showing since 2008. The pace of bank loan repayment slackened; bond issuance strengthened; net equity issuance turned positive, and even commercial paper made a modest contribution. As for SMEs, there is no evidence of volume gains, but a much larger percentage of small businesses have access to interest rates of 4% or less relative to last year. Lending spreads are very tempting for the banks, suggesting that competition will continue to weaken the cost of borrowing.

'Help-to-buy' debate

The weight of criticism of the government's Help to Buy programme, not least by the outgoing Bank governor, can be taken as a positive sign: to attract such opprobrium

suggests that few doubt its potential to have a definite impact on housing transactions and house building volumes. Much of the criticism surrounds the danger of reigniting house prices, yet a firm housing market is a necessary inducement to persuade vendors to offer their properties for sale.

Need to normalise Bank Rate

Against a backcloth of a lacklustre potential GDP trend, even a modest improvement in the outlook must be regarded as an invitation to begin the painful task of normalising the short-term interest rate. The era of ½% Bank Rate should have ended in 2010; instead it lingers on. The first steps towards rate normalisation – which might only be as far as 3% – should not be delayed. My vote is to raise Bank Rate by ¼% and to keep going.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking)
Vote: Hold Bank Rate and keep QE at £375bn.
Bias: Neutral.

UK economy's 'false dawn'

Is the UK economy at a lower business-cycle turning point? On the surface, it appears that it is. Economic growth was confirmed at 0.3% in the first quarter. Looking at the Purchasing Managers Indices (PMIs) for services, which is further above the breakeven level of 50; manufacturing, which is edging up towards 50, and construction, which is also pushing up towards 50, growth in the second quarter could be as much as ½%. Taking the first and second quarters together (assuming the latter is that just suggested) would give 0.8% growth in the first half of 2013.

There is some good news but…

Such an increase can be compared with the forecast of 0.6% for full year growth in 2013 made by the Office of Budget Responsibility (OBR) in March, and the Consensus Forecast of 0.9%. Moreover, inflation has fallen to 2.4% in April, with producer prices slipping and suggesting that pipeline inflation pressure is easing. The world backdrop is more stable than a few months ago, with financial markets in particular on the up, indicated by equity markets hitting new multi-year highs recently (though off those in the last few days). Employment gains are still holding up well in the UK and consumer and business optimism is trending higher than they have been at any point since the second half of last year. That means UK economic growth could end 2013 above 1% for the first time in three years. What better time to start to withdraw the extraordinary stimulus of the last few years?

…recovery narrative does not hold up well under scrutiny

The problem is that the recovery narrative does not hold up that well under scrutiny. First quarter growth was down to a sharp rise in inventories; without which real GDP would have contracted slightly. Also, there is no guarantee that national output will not fall back in the second quarter for the same reason – i.e., inventories but this time as the first quarter surge unwinds. The low paid jobs created in the last few years still leave consumer spending under pressure. Lower inflation helps household real income increases to be less negative, but nominal earnings growth continues to slide. Government spending is starting to be a drag on growth – if the first quarter figures are right – as fiscal retrenchment starts to bite. Our key export markets in Europe continue to struggle, with recession likely for eight consecutive quarters. Euro-zone GDP in 2013 as a whole is likely to be down by ¾%, a quarter of one percentage point worse than last year's decline.

Real drivers for sustained recovery are not yet in place

However, the issue is that it is difficult to see that the real drivers for sustained recovery are yet in place. Productivity continues to fall. Labour supply growth is positive but the jobs are low paid overall, and, together with the lack of investment in plant and machinery that is required to kick start productivity gains, the recovery in the first half of 2013 looks likely to fall back to just about flat in the second half. So, all in all, it is too soon to withdraw the stimulus. I would therefore leave rates on hold and keep QE at the current level, awaiting UK developments in the second half of the year. Let us see what the new Governor of the central bank thinks of all this when he takes over at the end of June. He will find that, in May, six members wanted policy to stay on hold and three (including the outgoing Governor) wanted to ease via QE.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (Beacon Economic Forecasting and University of Derby). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Commercial Banking). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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