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Shadow Monetary Policy Committee

March 2013

Embargo: Not for publication before 00:01am Monday 4th March 2013

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

In its most recent e-mail poll, which was finalised on 26th February, the Shadow Monetary Policy Committee (SMPC) decided by five votes to four that Bank Rate should be raised on Thursday 7th March. Three SMPC members wanted an immediate increase of ½%, while two advocated a rise of ¼%, implying a rise of ¼% on normal Bank of England voting procedures. This represented the second consecutive month that a majority of shadow committee members had decided that a rate increase was justified on economic grounds. However, no one expected to see an actual rate change this close to Mr Osborne's 20th March Budget. In addition, four SMPC members believed the British economy was so weak that Bank Rate should be held, while one believed that additional Quantitative Easing (QE) would be required before the economy could recover.

The majority view was that the stock of QE should be held at its present £375bn, however. Both the SMPC's 'hawks' and 'doves' included people who believed that QE would be more effective if the Bank bought more private-sector assets and relied less on government debt purchases. There was also disquiet about the extent of the structural fiscal weakness that might be revealed in the 20th March Budget. This might exacerbate the downwards pressure on Sterling that was initially triggered by Sir Mervyn King's comments at the 13th February *Inflation Report* launch and subsequently exacerbated by the removal of Britain's AAA rating by Moody's on 22nd February. The rapidly diminishing credibility of other aspects of UK policymaking made it difficult for the Bank of England to carry conviction, especially given its history of inflation overshoots, in the view of several SMPC members.

The SMPC is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 16th April and its minutes will be published on Sunday 5th May. The next two SMPC e-mail polls will be released on the Sundays of 31st March and 2nd June, respectively.

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Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate; no change in asset purchases.
Bias: Additional QE and a rebalancing towards non-gilt assets.

Weaker sterling is an important growth stimulus…

Over the last month, the trade-weighted value of the pound has fallen by another 3½%. Its total decline so far in 2013 has been roughly twice as large. The implied fall in Britain's real effective exchange rate (REER) represents an important stimulus to growth, given the economy's need to rebalance away from domestic spending towards net exports. The extent to which this nominal depreciation translates into a sustained real depreciation is unclear; there is a possibility that it could be dissipated in a higher price level. However, given recent experience and the considerable slack in the labour market, upward pressure on unit labour costs should remain limited and a lower REER is likely to persist.

…that reduces the need for further QE

This removes some of the urgency for additional Bank of England asset purchases. Nevertheless, the case for continuing monetary aggression remains strong. Indeed, a major driver of recent sterling weakness has been the Monetary Policy Committee (MPC) itself. Its recent pronouncements suggest a greater willingness to look through above-target inflation, an expectation of additional gilt purchases – three MPC members voted for another £25bn at February's meeting – and a desire to expand the authorities' monetary arsenal. The minutes of the latest meeting point to a wide-ranging discussion of other tools to boost activity in the UK. While the Bank remains reluctant to undertake these unilaterally, there does appear to be some support for co-ordinated action. Importantly, there seems to be greater consensus on the MPC of the dangers for long-term supply capacity of allowing demand growth to be persistently weak. In technical jargon, the MPC's 'reaction function' may include not just the output gap and the deviation of inflation from its target, but also the growth rate of output.

Powerful deflationary forces persist

This is sensible monetary policy-making in today's highly unusual environment. Even though Consumer Price Index (CPI) inflation is set to be above 2% into next year, the risks to inflation over the medium-term are limited. Powerful deflationary forces persist, including the on-going Euro crisis, the persistent failure to resolve global imbalances and widespread fiscal consolidation in the advanced world. A central bank concerned about wider financial stability and hysteresis effects on long-run supply capacity has a strong incentive to err on the side of doing too much. At the current juncture, this gives the green light for continuing monetary aggression.

And a need for better targeted monetary intervention

However, there is also an argument for more targeted interventions. A general expansion of the stock of broad money via gilt purchases remains a powerful tool, and should continue to be used where necessary to maintain adequate bank deposit growth; but there are good reasons to consider other types of action, including co-ordinated steps with the government, that would involve the purchase of non-gilt assets. The obvious parts of the economy that could be helped via such a mechanism are: the commercial property sector, the home building industry and the energy and transport infrastructure sector.

Comment by Anthony J Evans

(ESCP Europe Business School)
Vote: Raise Bank Rate by ¼%.
Bias: Raise Bank Rate further.

Current period of monetary stasis may be drawing to a close

Two things suggest that the present situation of Bank Rate at ½% and a £375bn stock of QE may be about to end. On the one hand, growth remains sluggish at best, and three members of the MPC wanted to increase QE last month. On the other hand, CPI inflation continues to remain above target, and the Bank of England seems increasingly likely to publicly admit that they are happy for it to remain so. Both sides of the debate are finding compelling evidence to support their positions. One might think that the so-called 'doves' are the pessimists, because they're still haunted by the (thus far, absent) threat of deflation. And the inflationary fears of the 'hawks' mark them as optimists, in the sense that they anticipate that past monetary easing will finally start kicking in. However, another way to view this is that by wanting to keep interest rates low indefinitely, the doves are implicitly assuming that once the present storm has passed it will be plain sailing. In other words, once the waters are calm again we can start to worry about exit policy. By contrast, the hawks may reject the idea that we are in the process of leaving the storm. Indeed, if one anticipates that there may be a deterioration in the health of the economy – whether it's through another US fiscal cliff, a Euro-zone crisis, double digit inflation, etc. – then we might view the present as an opportunity to repair our defence mechanisms before the real storm actually arrives. In this sense, we need to fully consider the opportunity costs of keeping interest rates unchanged, and the trade-off between prompting a crisis as against having the monetary policy tools in place to respond to a future one.

QE has delayed desirable market adjustments

As we prepare for the arrival of a new Governor, there seems to be greater attention being given to finding ways to loosen monetary policy. One of the problems with QE though is that the more successful it is the more it prevents markets from adjusting. The supposed positive impact of the Funding for Lending (FLS) scheme comes at the cost of propping up a housing market that is artificially high. In addition, interest rate guidance can backfire if the market interprets it as the central bank accepting that the recovery will be long and slow. Furthermore, it impedes the Bank of England's desire to have a clear communication policy about their target.

Need for a full and proper monetary-policy debate

Given that Nominal GDP is growing at a moderate rate, and growth in $M4^{ex}$ continues to rise – in December it hit 5.2% which is higher than it's been for more than two years – the economy is in reasonable shape. One can always find reasons to wait but there's even been good news on the fiscal front with a higher than anticipated surplus in January. The change in Governor also presents a window of opportunity to act. A moderate action would be to begin the process of raising interest rates back to their natural rate. This would make growth quicker and more sustainable, and also provide ammunition should external events cause a future deterioration. There is no reason to believe that raising rates would send a positive signal about the economy and boost confidence, but there's also no reason not to believe that. A more ambitious action would be to get serious about replacing the regime of inflation targeting. A Nominal GDP level target would help the Bank of England deliver monetary stability, and avoid the present challenges of trying to boost growth when inflation is above target. Most importantly, it would make future crises (caused by the central bank) less likely, because Nominal GDP is a better indicator of the monetary stance than CPI. Nominal

GDP targets do not rely on timely and accurate estimates of GDP, because you can target market expectations instead. Mark Carney has indicated that a debate about monetary policy would be a good thing. One has to agree.

Comment by John Greenwood

(Invesco Asset Management)
Vote: Hold Bank Rate.
Bias: Maintain asset purchases at £375bn; only increase the total to offset declines in M4^{ex}.

UK's relatively weak growth

Why has economic growth been so much weaker in Britain than in the United States? This is not something that can be explained by a superficial comparison of the components of GDP. Keynesian economists tend to focus on the role of fiscal stimulus, yet this does not provide a satisfactory explanation of the different performance of the two economies. There has been much blame heaped on the coalition government for its strategy of austerity. However, the UK's fiscal strategy has been ***less*** restrictive than that of the US when measured by the rate of narrowing of the budget deficit. Taking each year since 2009 and official projections for 2013 gives the results set out in the table below. In short, the US budget deficit has narrowed more, yet real GDP growth has been clearly superior to that in the UK. The explanation must lie elsewhere.

Table: Budget Deficits as Share of GDP (%)

	2009	2010	2011	2012	2013
US Deficit	-13.3	-11.2	-10.1	-8.7	-7.3
UK Deficit	-10.4	-9.9	-8.5	-8.2	-7.3

UK authorities started well but did not follow through

The evidence suggests several more fundamental factors that differentiate US and UK performance – namely the vastly greater leveraging up of Britain's banks during the bubble, the relative failure of the British government's measures to restore the health of the banks, and the more adverse consequences for the economy of British bank deleveraging. Ironically, the British government led the way in recapitalising the banks in the wake of the Lehman crisis, only to lose its lead to the US after the US Treasury's Troubled Assets Relief Programme (TARP) was adjusted to focus primarily on repairing the balance sheets of the banks.

US balance sheet repair has proceeded further than in the UK

In the United States, the total debt of all domestic sectors (household, non-financial corporations, financial corporations and government) has declined from 311% of GDP in 2009 Q1 to 255% in 2012 Q3, a decline of 56 percentage points. In Britain, by contrast, total debt of all corresponding sectors has declined only about half as much. From a higher absolute peak of 561% of GDP in 2010 Q1, UK total debt has declined to 529% of GDP in 2012 Q3, a decline of 31 percentage points. Basically, this means British households and institutions are having more difficulty repairing balance sheets than their American counterparts. Is it possible to pin-point the differences?

Major problem is Britain's financial sector

Drilling down into the debt ratios for individual sectors shows that both the household and the non-financial corporate sectors in Britain are lagging in their balance sheet repair. However, the major problem is in the UK financial sector. This is partly on account of its larger size relative to GDP, partly on account of British banks' high dependence on non-deposit financing (such as inter-bank borrowing and debt issues) during the credit bubble of 2003 to 2008, but also due to the adverse impact of financial sector deleveraging on the economy. Given the amount of balance sheet contraction that has been required of the banks, partly from regulatory pressure, and partly stemming from their own shareholders, creditors and customers, it was inevitable that banks should pass on the effects of deleveraging in the form of reduced lending and the imposition of tighter credit conditions to households and businesses.

Negative feedbacks and ineffectual British response

Just as there was a positive feedback loop in the financial sector during the bubble which meant that rising asset prices created more collateral for banks to lend against, so in the current de-leveraging phase a negative feedback loop has operated whereby lower asset prices and tighter credit standards have reduced the amount that banks are willing to lend. Above and beyond all of this, the British government's early measures to restore the health of the banking system were far less effective than the measures taken by the US authorities.

How America did it

The process of US bank rehabilitation consisted essentially of four main elements. First there was greater attention to restoring capital levels: the US Treasury and the Federal Deposit Insurance Corporation (FDIC) required immediate recapitalisation by ***all*** banks, much of it directly from the government in the form of preference shares, but some of it from market sources. Second, this was quickly followed by a series of demanding stress tests and further rounds of capital-raising where necessary. Third, the FDIC required the banks to take substantial write-downs against toxic loans, and to take back 'on balance sheet' at least $400 billion of securitised loans, cleaning up their balance sheets by late 2010. Finally, the US Federal Reserve provided large amounts of additional liquidity by means of its QE operations, pushing banks' excess reserves to $1.2 trillion by February 2010. In short, capital levels were greatly increased, loans were reduced, balance sheets were cleaned up, and liquidity enhanced. The net result was that US banks were able to embark on new lending by March 2011. Indeed, US bank lending has been growing at roughly 4% per annum since then – in marked contrast to the UK or the Eurozone where bank lending is still declining.

Fannie May and Freddie Mac

An additional factor that operated in the US but was not present in the UK was that the US banks were able to rely on the guarantees of the two giant nationalised housing agencies, Fannie Mae and Freddie Mac, which have served as an additional shock absorber for the mortgage portfolios of the US banking system.

UK officials' non-systematic and inadequate response

In Britain, the successive shock failures of Northern Rock, then RBS and HBOS seemed to paralyse the government and the Financial Services Authority (FSA). Instead of forcefully taking them over in their entirety or insisting on some minimum level of systemic recapitalisation for all the banks, things were handled on a non-systemic, case-by-case basis. A systemic approach seemed beyond reach, either because the government had already shot its bolt with its very large current spending at the onset of the crisis, or because the amounts of capital required would have threatened the government's AAA credit rating. In any event some banks, such as Barclays, were permitted to seek external sources of capital, while others like HSBC

did not have to raise capital at all. The stress tests conducted by the European Banking Authority (EBA) in Europe and the UK were widely regarded as noticeably more lenient than those conducted in the US, and the extent of loan losses imposed was much less damaging to banks' balance sheets. Consequently UK banks remained more leveraged and with less robust balance sheets than their US counterparts.

British banks have yet to complete their deleveraging process

As an example of the consequences of this different treatment of the banks in the UK, consider the results of their reliance on non-deposit funding. At the peak of the bubble in early 2009, banks were funding an astonishing £760 billion or 55% of GDP from non-deposit sources. The subsequent withdrawal of these non-deposit sources by wholesale, domestic or foreign, lenders is inevitably forcing banks to deleverage – either by reducing their lending, or by selling their subsidiaries, whether core or non-core businesses. Based on the latest data, bank lending that is funded from non-deposit sources was still £184 billion in December, or 10.8% of GDP in 2012 Q3. This means that the British economy and the British banks, in particular, still have further to deleverage before they can start to expand again without relying on leverage.

March Bank Rate recommendation

In view of this challenging backdrop, it is appropriate for the Bank of England to keep Bank Rate at ½% and for it to continue to provide additional liquidity as necessary in the form of QE operations if, and when, money and credit threaten to become too tight in quantitative terms.

Comment by Graeme Leach

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

A higher Bank Rate would reduce broad money and require increased QE to offset it

Monetary growth, the housing market and survey evidence point towards a muted recovery in 2013. Consequently, there is probably no need currently to adjust QE or interest rates. Any tightening in interest rates risks a further weakness in Britain's broad money supply at present. The argument for a tightening based on the misallocation of resources under QE is a tempting one. However, an immediate rate rise could prove counterproductive. This is because a higher Bank Rate could reduce the broad money supply, which would hasten the need for an offsetting, and economically distorting, expansion in QE in turn.

Comment by Andrew Lilico

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

Moody's downgrade was justified

The British economy has, as expected, been downgraded from AAA status – first by Moody's. Moody's key driver for this decision – the poor medium-term growth outlook for the UK – is entirely correct. Most discussion of growth policy in the UK is highly confused. Monetary and fiscal policy can move growth around in time, so as to achieve the country-wide equivalent of household consumption smoothing, limiting recessions in exchange for lesser booms. However, we need to recall the old truth that it is only supply-side and structural reforms that can increase medium-term growth rates, not government borrowing or loose monetary policy. That is the central lesson of macroeconomics of the past forty years, and yet people forget it so easily: if we

have a medium-term growth problem we cannot solve it with fiscal or monetary stimulus, since neither fiscal nor monetary policy can increase medium-term growth; they can only reduce it if they are done to excess.

MPC has effectively junked the inflation target

Monetary policy has passed that point of excess. Remarkably, at the last MPC meeting three members voted to increase QE even though the Bank itself forecast inflation to be far above target for years – illustrating how little the inflation target constrains policy any more. MPC members have stopped even pretending that their decisions to print extra money are driven by the need to avoid inflation falling below target several years hence in some model that systematically under-predicts actual inflation. Now they are content to vote for even more inflationary measures when they themselves say inflation will be above target.

But monetary policy cannot create medium-term growth

Monetary policy is a powerful short-term tool. It can limit damage during the first eighteen months of a severe recession. It can limit the peaks and troughs of more normal and gentle cycles. It can prevent inflation running away. What it cannot do is to create medium-term growth.

We now need longer-term policies to rebuild the economy

Interest rates were cut to near-zero in late 2008 and early 2009. Good. We started printing money from early 2009. Excellent! But at some point any serious economist should accept that monetary looseness has had its go and must make way for longer-term policies. Six years into the financial crisis, and four years into zero rates and quantitative easing, it is surely reasonable to ask whether the short term has now turned into the medium term.

Extreme monetary looseness has failed

To put the point the other way around: almost everyone is agreed that current policy is not working, and many say it's time to try something else. We have tried the path of 'über'-looseness and it did not work. Might we not, whilst there is yet time to try something else, try the path of merely extreme-looseness, tightening a little to see if it helps?

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.

Fundamental supply-side reasons for slow growth

It should be reasonably clear by now that the UK has slow growth for 'fundamental' or 'supply-side' reasons. First, the huge rise in raw material prices has impoverished us. Since the Bank of England has done little to stop this raw material inflation passing through into consumer prices, a rough measure of how much living standards have been driven down as a result is provided by the cumulated excess of inflation over the 2% target since 2006. This will be 7% up to the end of this year on the assumption that inflation averages 2.8% in 2013. The hike in raw material costs is probably the biggest element in causing the drop in real income; an adverse movement of this size in the terms of trade is just like a fall in productivity. Essentially, it means that, for the economy not to spend permanently more than its income, spending must drop by this amount. Notice that this cannot be offset by higher demand from government, say, because it is permanent; any attempt to do so would lead to excess international borrowing and hence solvency problems.

Spare capacity is limited to a few sectors and is not general

Along with this, there is a consequent fall in output, as permanently lower demand deprives various home-focused industries of their market: housing is the most obvious but other industries particularly affected by high material costs are also hit, notably transportation and travel. Hence we notice that certain sectors, such as volume cars and house building, have great excess capacity. However, since demand cannot be stimulated in a general way, this excess is 'structural' and has to be disposed of by accelerated depreciation. This is no doubt why measures of relevant 'excess capacity' (i.e., in sectors where there has not been the same structural collapse) are small.

Rundown of North Sea oil and banking industries

Then, we come to the collapse of the UK's two most productive sectors, North Sea oil and banking. This collapse appears to account for the bulk of the fall in labour productivity since the crisis. Both collapses were partly due to circumstances – with the North Sea, it was the exhaustion of extractable reserves and with banking, the crisis itself – and were partly due to government actions. With the North Sea our governments have been 'time-inconsistent', constantly changing the rules to squeeze extra income out of the industry; the extractive oil and gas industry no longer has much confidence that any further exploration/extraction efforts will not be milked by HM Treasury. With banking, the Coalition government has, as I have argued repeatedly, over-reacted in its new regulative agenda while also failing to restore bank competition; hence the industry is contracting sharply. This was an avoidable disaster.

Credit channel blocked by regulation

Finally, we come to the main side-effect of the banking collapse – the fatal blocking of the credit channel. This is another 'structural' element in our economic situation which is turning out to be non-remediable by monetary means; no amount of QE and bureaucratic schemes like FLS has loosened this constraint because the regulations create massive incentives for bank contraction.

Faulty wartime analogy

So, like it or not, our situation is one of weak growth forced on us by fundamental constraints. Only supply-side action can change this situation. Apologists for 'demand stimulus' argue that the government could spend more on infrastructure, which is true as borrowing against good long-term projects is not difficult and does not undermine solvency. However infrastructure projects are held up by planning and political hurdles, not particularly by lack of funds. Other apologists point to the effect of the Second World War in stimulating output. Of course, a war changes an economy's structure towards the production of armaments and military consumption, and a one-industry state can commandeer the means of production and force them to operate at high capacity; but in peacetime the economy is diverse and structural/supply-side issues have to be solved by peacetime policies to get the resources into the right places and permit growth based on market forces.

Monetary policy is in a difficult place

Where does this leave monetary policy? The answer is in a difficult place. QE and ultra-low interest rates are doing nothing to change growth, as one would expect. They are in fact massively distorting the market for savings by creating a privileged borrower, HM Treasury, at the expense of those committed to lending to it (e.g., for pension reasons). They are also subsidising bank profits on their existing balance sheet by giving banks a large arbitrage profit on the bank reserves produced by QE. Through this subsidy the present policy is distorting credit supply in favour of large existing firms, which seem like 'zombies' to be on bank life-support. It is time to put an end to these distortions and return to a realistic monetary policy that understands its limited capability.

Replace Britain's *de facto* banking cartel with a competitive structure and withdraw QE

If the government wants to stimulate money and credit, then it should look to the serious loosening of the new regulative framework and also a renewed push for bank competition, perhaps by break-ups of the large Treasury bank holdings into several smaller banks. In my view, the ring-fencing debate is an irrelevancy and an intrusion into industrial structure – the banks have argued persuasively that they need to be able to fulfil multiple functions. What matters is the number of banks and the competition they engender, which has been curbed sharply by the new cartelised set-up. Of course if the government did succeed in this loosening up, the huge overhang of QE would be an inflationary threat as existing bank reserves would be rapidly converted into credit expansion. Far better therefore to unwind this programme while there is still no threat, because the banks are immobilised by regulation. In summary, I recommend a rise in interest rates by ½%, no further QE, and a programme to unwind QE, while raising rates to normal levels, over the next two years.

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.

The 20th March Budget and imminent change of Governor make a rate change unlikely in March

With the UK Budget scheduled for 20th March and something of an inter-regnum in place at the Bank of England until Mark Carney takes over on 1st July, it is most unlikely that Bank Rate will be altered when the MPC meets on 7th March. In addition, it is improbable – albeit, possible – that any substantial new QE initiative will be announced, either. This does not mean that a rate rise might not be desirable on economic grounds simply that it is unlikely to happen. An interesting aspect of the MPC minutes, published on 20th February, was the sign that officials were already anticipating the more activist monetary stance believed to be preferred by the incoming Governor. This clearly helps to smooth the transition. It is possible that Sir Mervyn King's unexpected vote for an extra £25bn of QE in February reflected the discussions that he had been having with his successor. Given that a well-run monetary policy should minimise the shocks it delivers to the real economy, this would all be very reasonable and civilised if that is what actually transpired.

Worrying parallels with the 1970s

Such civilised niceties should not be allowed to disguise the fact that UK fiscal policy is now massively – and, humiliatingly for Mr Osborne – off course and that British policy makers are losing their credibility in the financial markets, as can be seen from the decision by the Moody's rating agency to withdraw Britain's AAA rating. One result is that a 1976 style stabilisation crisis can no longer be ruled out, particularly as we draw closer to the 2015 general election date and the prospect of a Labour government or a Labour/Lib-Dem Coalition. For anyone who remembers that period, there are aspects of the current UK economic conjuncture that are reminiscent of the policy errors of the mid 1960s and early 1970s that culminated in the December 1976 International Monetary Fund (IMF) bail out of the British economy. First, the groundwork for the mid 1970s crisis was laid because the supply performance of the economy was severely damaged by the more than 10 percentage point increase in the share of government expenditure in GDP under the 1964 to 1970 Labour government, just as it has been by the broadly similar rise between 2000 and 2010. Second, in both cases, the growth of potential real GDP collapsed to some 1% to 1½% per annum because of the 'crowding out' – particularly, of private investment – that resulted.

However, the authorities failed to adjust their policies accordingly, ran an unduly lax monetary policy and created stagflation, not growth. Third, between 1970 and early 1974 an ineffectual Conservative administration then tried to use a Keynesian demand stimulus to boost the economy, in which they were aided and abetted by a central bank which was politically subservient and intellectually soft on inflation. Finally, and following the humiliating collapse of the Conservative Heath administration in February 1974, the new Labour government let public spending rip, ignored rising inflation and the deteriorating trade deficit, aggressively raised taxes, and piled populist intervention upon intervention, until the markets finally lost patience.

Currency depreciation is associated with reduced activity, not stronger, as the Bank seems to believe

One important difference with this earlier period is that the recent growth of broad money and credit has tended to be too low because of a misguided and pro-cyclical regulatory tightening, whereas the mid-1970s still suffered from the monetary overhang build up in the earlier Heath-Barber credit boom. However, accelerating inflation can result from a collapse in the exchange rate in a small, open and trade-dependent economy such as Britain's. Furthermore, higher inflation does not have to be validated by a faster monetary expansion if the real exchange rate falls. The real exchange rate can tumble out of bed because the perceived post-tax rate return on human, physical and financial capital is reduced – perhaps as a result of higher taxes or populist anti-business rhetoric – or if the markets lose faith in the competence with which the economy is managed. The present Governor seems to believe that a weaker pound is necessary to re-balance the economy and to stimulate private demand. However, it is by no means certain that a weaker pound is indeed stimulatory. Whether or not currency depreciation boosts activity is essentially a quantitative question that depends on the deeper structure of the economy and the precise values of certain key parameters. A lower exchange rate will increases activity if: 1) the price elasticities of demand for exports and imports are high; 2) the pass through from the exchange rate to domestic prices is partial and slow; 3) higher inflation does not provoke adverse feedbacks, such as a rise in the savings ratio, and 4) there is ample spare capacity in the sector of the economy that engages in international trade. The Bank has published remarkably little research as to whether these conditions are currently satisfied. Instead, official rhetoric sometimes appears to be re-cycling a warmed up version of 1960s Cambridge Keynesianism, which implicitly assumed that these conditions held.

Reasons why lower sterling will weaken activity

Unfortunately, it is no longer possible to examine the properties of a wide range of UK macroeconomic forecasting models to see how far these conditions are satisfied, as one could have done twenty or thirty years ago. Indeed, we are still waiting for details of the Bank's new forecasting model COMPASS to be published, although that is promised to happen in the next few months. For what they are worth, the properties of the current version of the Beacon Economic Forecasting (BEF) macroeconomic model suggest that: 1) competiveness elasticities have fallen sharply and consistently in recent decades and may now be zero in the case of imports; 2) the pass through from the exchange rate to domestic prices is eventually 100%, and 3) higher inflation reduces activity through a range of mechanisms. That high and variable inflation reduces growth has also been found in international panel data studies, which try to explain the long run growth performance of a set of countries, and also in much of the empirical work published in the 1970s and early 1980s. The Bank's apparent belief that higher inflation is positively associated with stronger activity appears to have forgotten this earlier research, which generally indicated the opposite. Finally, one must have reservations as to whether an economy with some 5½ million government

employees and some 2½ million working in manufacturing – which is the current British situation – has the same capacity to increase output in response to a lower exchange rate as one with 3¾ million government employees and 7¾ million in manufacturing, which was the UK situation in the mid-1960s, for example.

Mr Osborne's failed Type 2 fiscal stabilisation attempt

As far as the forthcoming 20th March Budget is concerned, "sufficient unto the day is the evil thereof" applies. However, it needs emphasising that, in terms of the fiscal stabilisation literature, all that Mr Osborne has attempted has been a 'timorous Type 2' fiscal consolidation programme, in which tax increases have been front-end loaded, public investment has been cut, and current government expenditure and welfare costs allowed to rise. There exist countless international studies showing that Type 2 packages lead to unexpected output weakness and a worsened fiscal position. One can only despair at either the quality of the advice that the Chancellor has been receiving, or his willingness to listen to it. In contrast, a 'bold Type 1' package of tax cuts, public consumption reductions, tight control of welfare bills and no public investment cuts – which the Conservatives should have prepared while in opposition and then implemented immediately – is normally associated with positive output surprises, reduced joblessness and an improved fiscal position.

Four chinks of light amidst the gloom

However, before giving up in despair it is worth noting four chinks of light penetrating the gloom. The first is the recent strength of world equity markets, which might be regarded as a longer-leading indicator of the economy. Some central bankers have expressed concern that this development represents a return to bubble conditions. However, the normal monetary transmission mechanism is for financial markets to respond first to monetary stimulus, and then commodity prices, before activity picks up and eventually inflation at the end of the process. The second has been the consistent acceleration in the growth of the $M4^{ex}$ broad money measure from 1.5% in December 2011 to 5.2% in December 2012. This development could be derailed easily by ill-considered regulatory interventions. However, if the acceleration continued much further, there could be concern about its longer-term inflationary consequences. Third, there has been the parallel and linked turn round in the housing market, with the Office for National Statistics (ONS) house price index declining by 0.4% in the year to December 2011 but rising by 3.3% in the year to December 2012. Finally, there has been the continued decline in both official measures of joblessness. This development may encourage consumer confidence, even if it is hard to reconcile with the ONS growth figures.

The March Bank Rate decision

As far as the March Bank Rate decision is concerned, the breakdown of fiscal discipline, the recent weakness of sterling, the faltering market confidence in UK policy making, and the likelihood that higher inflation reduces activity, suggest that it is time to introduce a ½% hike in Bank Rate. This is not because of any economic effects that it might have, which would be small, but in order to demonstrate that the Bank of England has not just become a supine underwriter of fiscal profligacy. A second reason to raise Bank Rate is to head off the possibility of a major run on the pound developing because speculators would no longer face a one-way bet after a rate rise if they short sold sterling. The stock of QE should be left where it is for the time being and only added to if broad monetary growth threatened to nosedive, perhaps as a result of renewed problems in the Euro-zone. Because recent UK inflation overshoots have probably reduced economic activity, it is now time to say enough is enough. The Bank of England should act with the same counter-inflationary resolve as the pre-EMU

Bundesbank would have done under current circumstances and not as it did itself in the 1960s and 1970s when Britain was reduced to the 'sick man of Europe'.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%; diversify existing QE into non-gilt assets.
Bias: To raise Bank Rate.

Even greater monetary disarray

UK monetary policy has been thrown into even greater disarray, if that were possible, by speculation over impending changes in HM Treasury's remit to the Bank of England, hints that incoming governor Mark Carney will alter the substance and style of policy and the news that the present Governor voted with a minority to raise the amount of QE to £400bn. The side effects of these developments, especially their impact on overseas holders of Sterling, are unequivocally bad for inflation outcomes. The latest Bank of England *Inflation Report* contains a notably downbeat inflation assessment and Martin Weale's balance of payments speech spells out the risks of external inflation.

Commence normalisation of Bank Rate now

While there may be some glimmers of hope regarding UK output and export volumes for the year ahead, these remain vulnerable to the resumption of debt hostilities in the Euro area and the potential for disappointment regarding the FLS. Nevertheless, with a more stable demand outlook than seemed possible a few months ago, the time to begin the normalisation of Bank Rate is now. It would serve the added purpose of rebutting the charge that the Bank of England has forsaken its responsibility to preserve sound money. There remain four months before Mark Carney arrives. This is far too long an interval to allow the weak Sterling trend to go unanswered.

Current monetary approach is depressing enterprise

The Bank of England must not lose sight of its goal of normalising short-term interest rates. Running policy on the basis of a permanent emergency is sending a depressing message to the entrepreneurial sector. If there is a role for 'forward guidance', it is to reassure of the Bank's determination to take rates back to the region of 2% to 2½% over the next two years, beginning with a move to ¾% immediately.

QE should buy private assets

The suggestion that the Bank should consider the purchase of other assets besides gilts is worth pursuing. The Bank of England could learn from the experience of the Bank of Japan, that relatively small purchases of private sector assets – for example commercial property, exchange-traded equity funds and commercial paper – could have potentially more powerful effects on the real economy and business confidence than further huge purchases of government debt. At the same time, the gradual withdrawal of Bank funding of the budget deficit would help to discipline fiscal policy.

Comment by Trevor Williams

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

UK economy remains broadly flat

So far this year, the economic data in the UK have continued to be broadly flat: some indicators have pointed to faster growth others to slower. There is as yet no decisive trend suggesting a sustained recovery is underway. That said the economy will probably grow this year compared with last but only a lacklustre recovery, with growth

close to 1%, seems on the cards at present. It is not a recovery that leaves the MPC comfortable that enough has been done, if the minutes of the February meeting are anything to go by. Clearly, it has also left the rating service Moody's uncomfortable as it cited weaker growth than expected at this stage of the recovery as the principal reason for the decision to downgrade the UK's credit rating from AAA to AA1. That having been said, the downgrade was not a huge surprise and probably means very little for the UK's cost of borrowing. After all, official borrowing costs have remained low in the US and France – which is, probably, the better example for the UK – even after they were downgraded.

SMPC content with continuing inflation overshoots

However, the MPC still appears comfortable with the prospect of inflation remaining above the 2% target until 2015. We know this because they said so. The voting at the February meeting showed that Governor King and Paul Fisher joined with David Miles in wanting more QE but these three were outvoted by the six other members of the Committee. This suggests that the biggest concern for the three is economic growth (is there more bad news in the forthcoming data that they are aware of?) and that even above target inflation would be accepted. Actually, the minutes showed that the whole MPC accepted above-target inflation, but the three dissenters wanted further easing now, implying a greater willingness to risk inflation for growth. Of course, their view is that inflation will eventually fall below target, if no action is taken now to boost the economy. In other words, that there can ultimately be no long lasting inflation threat if growth stays weak. For now, the financial markets have accepted this, although inflation expectations are creeping up.

No sign of cost-push inflation

To some extent this is borne out by the latest labour market data, which showed wage inflation of just 1.4% in the year to December. With consumer price inflation running at 2.7% this implies a drop in real pay of 1.3%. If there is sustained consumer price inflation, it certainly seems unlikely that it will be of the cost-push variety. However, producer price inflation did come in higher than expected, with the usual suspects of higher food prices and utility charges to blame. Meanwhile, manufacturing shows only a modest recovery and retail sales continue to struggle, though UK automobile sales remain remarkably resilient.

The productivity puzzle

Claimant count unemployment fell by 12,500 in January (with December's fall revised to 15,800 from 12,100). The Labour Force Survey (LFS) measure of employment surged again, and was up by 154 thousand in the fourth quarter of last year. With GDP contracting again in 2012 Q4 this suggests that the UK productivity puzzle – i.e., why it has remained so sluggish – continues. The softening in annual earnings growth to 1.4% on a headline basis in the three months ending in December is consistent with weak productivity gains. The problem is that weak productivity is consistent with weak growth, so how to break the link? Perhaps the Budget on 20th March may have something to say on that score.

Lloyds Bank survey suggests growth was around ¼% in 2013 Q1

My vote is for keeping interest rate at ½% and QE at £375bn for now, but with a bias to ease via more QE but with more variety in the assets being purchased. If economic activity weakens further - or shows no signs of recovering - economic growth in the first quarter of this year looks like it will be around *plus* ¼% or so, based on data from the latest Lloyds Bank Commercial banking's business survey. If this growth projection still holds as more data for 2013 Q1 are released, it may not be enough for the MPC. After the action from Moody's, they may be even more willing to try to boost the economy than before.

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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