Lombard Street Research

Independent • Objective • Creative

Shadow Monetary Policy Committee

May 2012

Embargo: Not for publication before 00:01am Monday 7th May 2012

IEA's Shadow MPC says No to more QE, with four voting to raise interest rates immediately — Proposal to raise rates defeated only by five votes to four

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 17th April, the Shadow Monetary Policy Committee (SMPC) decided by a narrow margin of five votes to four that UK Bank Rate should be held at ½% on Thursday 10th May. Three members of the shadow committee wanted to raise Bank Rate by ¼%, while a fourth argued for an increase of ½%. This result reflected the increasingly 'hawkish' trend in the SMPC vote that has appeared during recent months, while still leaving a narrow majority in favour of holding rates. All the IEA shadow committee members recognised the uncertainties attached to UK economic developments, events in the Eurozone, and the need to restore financial balance sheets, and were well aware that a flexible and pragmatic response to events was the only sensible course.

Most SMPC members thought that there should be no additional QE in the short term, although there was a divergence of view with respect to the appropriate policy subsequently. Some members believed that further QE tranches would be required because of the weakness of the economy, others wanted to hold the existing stock, and one member thought that QE now needed to be unwound to avoid longer-term inflation risks. The SMPC poll was finalised after the disappointing March inflation figure, which was released on the morning of the gathering, but before the publication of the negative first quarter real GDP growth figure on 25th April. However, the SMPC had already concluded on 17th April that the official data was no longer fit for purpose where the national accounts were concerned.

The SMPC has gathered quarterly at the IEA since July 1997. That it was the first such group in Britain, and that it assembles regularly to debate the deeper issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts exactly nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent SMPC analyses are correspondingly more significant than the precise vote. The latter is not intended as a forecast of what the Bank of England will do but as a declaration of what the SMPC believes it should do. The following two SMPC e-mail polls will be released on the Sundays of 3rd June and 1st July, respectively. The next SMPC meeting will be held on Tuesday 10th July and its minutes will be published on Sunday 29th July.

For Further Information Please Contact:

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

For Distribution Enquiries Please Contact:

Pippa Courtney-Sutton +44 (0) 20 7246 7811 pippa@lombardstreetresearch.com

Minutes of the meeting of 17th April 2012

Attendance: Phillip Booth (IEA-Observer), Roger Bootle, Anthony J Evans, John Greenwood, Ruth Lea, Andrew Lilico, Patrick Minford, David Brian Smith (Chairman), David Henry Smith (*Sunday Times* Observer), Peter Warburton (Acting Secretary), Trevor Williams.

Apologies: Tim Congdon, Jamie Dannhauser, Kent Matthews, Akos Valentinyi, Mike Wickens.

Chairman's comments

Introductory comments

The Chairman started by suggesting that it would be useful to expand the range of issues discussed by the shadow monetary committee now that Bank Rate had been unchanged for some three years. He added that individual SMPC members had addressed wider macroeconomic and regulatory issues in the SMPC polls – something he wanted to encourage – but asked members to give further thought as to how the committee's analysis might be made even more policy relevant. He then asked John Greenwood to present the monetary situation.

The Monetary Situation

International economic background

Contrast between rapidly developing countries and older industrialised ones

John Greenwood started by distributing a detailed presentation pack. He then proceeded to structure his comments around: the contrast between developed and emerging economies; a more detailed consideration of the international monetary situation, and, finally, the UK domestic monetary situation. He noted that for the emerging economies - but especially those in Asia and Latin America - their last real financial crisis had been in 2002. After a turbulent period from around 1994, when some Chinese banks had suffered an insolvency crisis, through the Asian financial crisis that started in Thailand in 1997 and continued for the rest of the 1990s there had been frequent crises in emerging economies. However, these nations had enjoyed a relatively high degree of stability during the past decade. This stability had been characterised both by current account surpluses and by a non-participation in the credit and housing bubble that had afflicted many Western economies. Household and corporate balance sheets were in good shape in much of Asia and Latin America. This meant that monetary and fiscal policy tended to gain traction quite quickly.

Malign legacies of housing and credit bubbles

He contrasted this situation with that of the developed economies where the malign legacy of the credit and housing bubbles were still very much with us and where many countries still suffered current account deficits and households and financial institutions remained over-indebted and needful of balance sheet repair. In this context, monetary and fiscal policies were finding it difficult to gain traction, at least, policy in the conventional sense. John Greenwood continued this characterisation by observing that interest rates had been rising in emerging economies recently. Private sector credit demand had been relatively rapid and reflected in strong money supply growth. Furthermore, GDP growth was quite robust in many emerging economies and inflation had become more embedded. This meant that investors were looking for

inflation protection. By contrast, in developed economies, interest rates remained exceedingly low. Nevertheless, the private sector demand for credit was still historically weak, giving rise to slow money and credit growth. GDP was only making an erratic recovery. In his opinion, inflation problems were transient and investors were focused on a search for yield.

Issues facing the US economy

John Greenwood illustrated the points he was making about the indebtedness of the developed economies by showing a series of slides on the US. His observation was that deleveraging in the US had made its biggest impact in the financial sector, while the government sector had been taking on more leverage in relation to national GDP at the same time. However, the US had perhaps been the most successful of the developed countries in reversing its excessive debt. In fact, the most recent US data showed a recovery in corporate and household credit market debt. The growth rate for the US non-financial corporate sector had risen above 6% in early 2012, while the household sector had improved but was still in mildly negative growth territory. The overall result had been a growth of about 2% in US net private sector credit demand. John Greenwood noted that government borrowing was still playing an important role in replacing the sudden decline in private sector borrowing. He linked that particularly with the shrinkage of the 'shadow' banks. These he defined as broker dealers, financial companies, issuers of asset backed securities, funding corporations such as Structured Investment Vehicles and conduits and money market funds. The shadow banks had declined in asset size by around $4.8 trillion since their peak in 2008. John Greenwood stated that a flight to quality from non-banks to banks was an important phenomenon in America. He then drew attention to the fact that the M2 measure of US broad money supply had risen above the value of bank credit reflecting a desire for the liabilities of the banking system as opposed to the liabilities of the shadow banks. He also reflected on the recovery of US bank lending, which was now growing at about 5% per annum. In addition, he drew attention to two important distortions to the data that have arisen in the last three years. As a consequence of the flight to quality, the growth in US M2 broad money had been running at around 10% since August 2011. The shadow banks had stopped falling as violently as before but were still contracting at approximately 6% per annum. John Greenwood's conclusion was that growth of the borrowing aggregate remained insipid once the shadow banks were combined with the institutions in M2. Turning to US economic growth, John pointed out that there had been an upward revision to the consensus forecast for US real GDP growth in 2012 in recent months from a low of 1.9% to 2.3% currently.

Problems in the Eurozone

Moving on to the Eurozone, John Greenwood remarked how there was a deceleration in bank lending in the most recent months, particularly the closing months of 2011, and hardly any annual growth at all. M3 money supply continued to grow a bit faster at just over 2%. Breaking this down, John Greenwood considered that the money supply in the core Eurozone economies was generally growing somewhere between 2% and 6% currently. This contrasted with the situation in the peripheral economies, where with the exception of Ireland (which was enjoying double-digit money supply growth), Italy, Spain, Greece and Portugal were demonstrating particularly negative monetary trends towards the end of last year. In Greece, M3 was contracting at more than a 15% annual rate. John Greenwood reminded the shadow committee of the structural causes of the Eurozone crisis, namely the divergence of unit labour costs in the peripheral countries from those in the core. He pointed out that, despite the abatement in unit labour costs in Ireland and Spain (but not yet Italy), this had gone a very small way to closing the cumulative gap that has opened up with respect to Germany. He

turned to the current-account imbalances within the Eurozone where Germany had recorded consistent current-account surpluses since 2005 whereas the peripheral countries of Italy, Spain, Portugal and Ireland had recorded collective deficits. Whereas these current account imbalances had been financed voluntarily through private flows until 2008, the financing had been from official flows directed from the core of the Eurozone since 2009 or 2010. Growth forecasts for the Eurozone in 2012 had been revised down heavily. In the spring of last year, the consensus expectation was for a 1.6% growth rate this year. This figure has declined to around *minus* 0.4% for 2012. Growth expectations for 2013 are also subdued at less than 1%.

China and other Asia

Turning to China, John Greenwood noted that the country had avoided the credit bubble that had spread through the American financial system during the 2000s before the 2008 financial crash. However, China had been making its own response to the global credit crisis and had suffered a dramatic expansion in credit and broad money growth from late 2008 onwards. John Greenwood questioned whether there were serious bubble risks elsewhere in Asia. He pointed to money and credit growth in a variety of countries including Korea, Taiwan, Hong Kong, Singapore, Malaysia, and Thailand. He noted that these growth rates were comfortably in the 10% to 15% annual range. He was more concerned about bubble risk in Latin America where monetary growth had accelerated and a composite M3 calculation for Brazil, Mexico and Chile currently reported 18% annual growth.

UK monetary background

Weak demand for credit from UK private sector

John Greenwood next discussed the UK monetary background. He characterised it as follows. There was still only a weak private sector demand for credit, which he attributed to the urgency of deleveraging, and noted also that household incomes had been eroded by more rapid inflation than in the past. M4 broad money excluding intermediate other financial corporations – hereafter, $M4^{ex}$ – was still demonstrating only very weak growth in the low single digits per annum. Banks net lending to businesses continued to contract although there had been some small improvement in lending to small firms. On the whole, mortgage lending was still subdued. He viewed the coalition government's fiscal cutbacks so far as modest. Nevertheless, the promise of spending cuts had still helped sterling to revive from around US$1.43 to the low US$1.60s and gilt yields had dropped from 3.8% to 2.1% in the case of a ten-year benchmark bond. The level of GDP remained over 4% below its peak value prior to the crisis and he expected only a negligible improvement for 2012 Q1 with little sign of the officially-desired rebalancing to exports or investment at this stage. Inflation had been 3.5% on the CPI measure in March but he thought that it was likely to fall back towards 2% to 2.5% by the end of 2012. He also mentioned the end of the stamp duty holiday for properties sold for less than £250,000. Some of the recent growth in mortgages and approvals may not be continued now that the deadline for this stamp duty holiday had passed at the end of March. He found it difficult to envisage a corporate-spending led recovery and suggested that household sector would have to recover before the corporate sector felt confident enough to expand its own spending. The UK's debt ratios had shown modest decreases for households and for non-financial companies. However, and as with the US, there has been a compensating rise in the government debt ratio which stood at 64.3% of GDP on the measure that excluded financial sector support. $M4^{ex}$ showed around 2% annual growth but headline M4 and M4 lending were both languishing at around *minus* 3% annual rates.

Limited impact of QE on monetary statistics

John Greenwood then showed the SMPC some other charts, which illustrated the weakness of bank lending to the private sector and the progressive decline in the value of unused sterling credit facilities of UK monetary and financial institutions over the past four years. Turning to the Bank of England's Quantitative Easing (QE) policies, he noted that QE, at currently £325 billion, had not yet had a great impact on the broad monetary statistics and he expected the stock of QE to be extended beyond its current level. In the property market, he drew attention to the flatness of domestic house prices over the past year. The headwinds for personal consumption growth included weak employment and income growth. Thus, the rate of Labour Force Survey (LFS) unemployment was currently 8.4% and the claimant count measure of joblessness approximately 5%. Expressing household employee earnings growth in real terms resulted in the calculation of *minus* 2.9% in the year to January continuing the trend in the last couple of years of weakening real earnings growth. Retail sales volumes had been erratic but mildly positive. The survey measure produced by the Confederation of British Industry (CBI) had often been a bit brighter than the official retail sales figures. Even so, the CBI results had been hovering around the zero line indicating little or no positive momentum behind sales volume.

Conflicting output indicators but inflation expectations remain subdued

Manufacturing production lagged CBI's expectations and we had to wait to see how that would be resolved, in John Greenwood's view. The order balance on the CBI measure was better than the capital expenditure measure thanks to stronger overseas orders and weaker housing. UK GDP remained almost 4% below its pre-crisis peak, with investment and consumption being laggards. There had been early signs of spending restraint by the government. Nevertheless, the task of eliminating the budget imbalance was daunting. John Greenwood had used the UK breakeven inflation expectations data to derive a measure of financial market inflation expectations. He deduced that these expectations remained subdued. John Greenwood was looking for CPI inflation to fall from its current 3.5% due to an easing in commodity prices and for this fall in inflation to revive real spending power in the economy. He expected another year of minimal growth until there was a stronger environment for consumer spending. The Chairman expressed his gratitude to John for leading the meeting through this detailed analysis. He then threw the meeting open to discussion.

Discussion

QE an 'enormous hostage to fortune'

Patrick Minford opened the debate by saying that he believed QE represented an enormous hostage to fortune and that he was concerned about the potential for highly inflationary scenarios to develop. It was his opinion that we were employing regulatory overkill and were removing the incentives for banks to lend and take on more risk. The regulatory requirement to hold more capital had raised the wholesale cost of funding and was acting as a gratuitous break on economic recovery. He was worried by the negative effect on the supply side of the economy arising from a still bloated public sector and regulatory impediments to the financing of businesses. Patrick Minford expected slow production growth and indeed stalled global economic growth because of these policy errors. Furthermore, he believed that UK bank-regulatory policy had been pro-cyclical exaggerating the positive phase of the cycle and aggravating the negative phase. QE had produced little beneficial effect on credit growth and had mainly served to offset the negative consequence of the overregulation that has taken place. This was a blatant case of policy inconsistency.

QE defended as a partial success

Roger Bootle found it difficult to understand the strength of Patrick's feelings about QE and believed that QE was working, albeit to a limited extent. He also believed that there had been portfolio effects arising from QE that had benefited the corporate sector. If QE had not been undertaken, sterling might well have appreciated in a way that would have further damaged UK recovery potential. In consequence, Roger Bootle supported the continuation of QE.

Forthcoming rebasing of the UK national accounts

David B. Smith then drew the meeting's attention to the fact that the Office for National Statistics (ONS) had indicated that it will be rebasing the national accounts to 2009 prices in late June, which was only six months after the ONS had belatedly published back runs for the current 2008 price data just before Christmas 2011. This rebasing of the accounts would again destroy the continuity of data and cause a serious problem for macroeconomic modellers and forecasters in both the private and government sectors. He thought that the GDP data were now so unstable and ineptly put together that he had lost all faith in the official figures. He also noted that the responsibility for official house price statistics had been transferred from the Department of Communities and Local Government (DCLG) to the ONS.

What would happen to rate spreads if Bank Rate was increased?

David B Smith then commented that the effective marginal rate at which commercial banks could borrow in the money markets was now somewhere around 3¾% so the gap over bank rate was probably some 3% to 3¼% rather than the ¼% to ¾% or so that would once have been considered normal. He then returned to a question that the SMPC has frequently considered in the past, without reaching an agreed conclusion. That is, if the Bank Rate were to be raised, would the gap fall to a more normal level so that it would be possible to raise Bank Rate without substantially altering the cost of corporate and mortgage borrowing? The Treasury had suggested not; its view was that any rise in Bank Rate would be passed through the interest rate structure to increase the interest rates paid by borrowers.

Bank Rate remains important but only in specific contexts

Roger Bootle replied that Bank Rate remained important in certain specific contexts. In particular, it represented the interest rate that banks received on their deposits at the Bank of England and it was embedded in many private sector contracts including mortgages. The repo rate at the Bank of England was also tied to Bank Rate. Andrew Lilico pointed out that the present very low Bank Rate only impacted on a shrinking proportion of commercial bank balance sheets as banks were now being forced to fund themselves from the retail sector. Furthermore, the relationship with gilt rates was not clear-cut; the abnormally low Bank Rate had had the additional consequence of undermining the medium term growth of the economy by reducing the risk-free rate. This had the effect of lowering the cost of capital but also the real growth of the economy.

Private investment crowded out by political and tax uncertainty

David B. Smith then spoke about the impact of the large budget deficit on private investment. He believed that private investment was being crowded out by this large deficit because of the uncertainty it induced over future business taxation. Certainly, statistical models of private investment found that large budget deficits had a powerful independent negative effect on private fixed capital formation, after allowing for other obvious influences such as the level of activity, real short-term interest rates and taxes. There was a perception that the government was less than fully supportive of the business sector creating a political risk. In an environment where world trade growth was decelerating - and with it the demand for UK exports - this gratuitous political risk was yet another impediment to the recovery of UK business spending. He

argued for tax and regulatory uncertainty to be ended – and for senior politicians to cease their mob-pleasing anti-business rhetoric – to pave the way for a better supply-side environment.

Query about UK's sustainable growth rate

Andrew Lilico next raised the question of the sustainable growth rate of the UK economy; he suggested that the two main functions of monetary policy had been to maintain an appropriate rate of growth of money in the economy consistent with low and stable inflation and also to smooth out temporary shocks in the economy. He found it hard to justify the continued emergency low interest rates on the basis that the Office for Budget Responsibility (OBR) was forecasting 0.8% GDP growth this year. He believed that this was close to the current sustainable growth rate of around 1%. He questioned whether there was a crisis of demand growth as distinct from a poor supply performance and suggested that it was now time for interest rates to be moved back towards a more normal level.

Restoration of corporate balance sheets

Andrew Lilico then expressed his disagreement with John Greenwood's pessimistic outlook for corporate sector spending; John had interpreted the building up of large corporate cash balances as an anomaly and supposed that there was a backlog of investment opportunities that had not been undertaken, implying that capital formation would catch up on these delayed investments. John Greenwood replied that the recovery of balance-sheet health was a more urgent priority than capital spending when balance sheets had been disturbed. This meant that he believed that corporate sector balance sheets would de-lever in preference to a new investment cycle.

Unrealistic OBR growth assumptions

Ruth Lea took issue with the longer term potential growth projections of OBR, that although the short-term growth profile was weak the OBR expected growth to reach its potential 2.5% annual growth within a few years. She believed this was not achievable. If that was the case, then the fiscal targets set out in the budget report were also unattainable.

Laughable official forecasting models

David B. Smith bemoaned the lack of proper supply-side modelling on the part of the OBR and the Bank of England. He noted that the OBR had inherited its forecasting approach from the Treasury and now badly needed to completely rebuild the grossly inadequate forecasting methodology that it had been bequeathed. A model such as the OBR/HMT one, which set both the growth rate and inflation exogenously by assumption, would have been laughed at as hopelessly inadequate and cut off without a penny if it had applied for Economic and Social Research Council funding thirty-five years ago.

International influences on British inflation

Peter Warburton raised the issue of the contrast that John Greenwood had made between the embedded inflation in emerging economies and what he viewed as an only transient inflation in developed economies. Peter Warburton expressed a contrary view that there was a powerful international inflation transmission running essentially from the producer economies in the emerging world to the consumer economies in the developed world and that this international transmission of inflation would compromise the inflation objectives of developed country central banks. The Chairman then stated that it had been a fascinating and wide-ranging discussion. However, time had run out and it was now time to take the votes of the nine members present. These are arranged in alphabetical order, in line with the normal SMPC practice.

Comment by Roger Bootle

(Capital Economics)
Vote: Hold Bank Rate.
Bias: To increase QE as necessary.

Political context of monetary management

Roger Bootle was asked to give his vote for the meeting. Roger spoke about the political context of monetary management. He believed that it would be relatively straightforward to soak up the additional liquidity that the central bank has popped into the economy from a technical perspective. However, he feared that politicians might actually want inflation and that the outcome was not necessarily dependent on the monetary system in isolation.

Politicians possibly desired inflation squeeze on real incomes

He viewed the inflationary squeeze on real incomes in the UK as possibly being what politicians had desired to happen. However, he thought that inflation would fall more consistently and further this year allowing real incomes to grow again and consumer spending to recover in 2013. He foresaw a modest sign of that revival but there was still plenty of spare capacity in his view. Average earnings growth was not picking up and commodity prices could go badly wrong - i.e. weaken significantly - so he saw a potential for the inflation rate in the UK CPI to keep on falling. His vote was to keep Bank Rate unchanged with a bias to do more QE if the economy weakened. Roger Bootle wanted no further QE at the May meeting but favoured the expression of a willingness to do more if the demand side of the economy continued to be weak.

Comment by Anthony J Evans

(ESCAP Europe)
Vote: Raise Bank Rate by ¼%.
Bias: Hold QE.

QE now subject to rapidly diminishing returns

Anthony J. Evans spoke of the problem of the counterfactual to QE, that it was difficult to demonstrate that an economy would not have been much weaker in the absence of QE. However, he believed that QE was subject to a diminishing effectiveness and he was sceptical of its further use. He regarded the supply-side issues as still needing to be resolved and that the conditions for increasing interest rates were present on the basis that the Eurozone crisis had receded temporarily. He asked the questions, what would be the trigger for a bank rate increase? Would it be to wait until inflation expectations had reached 5%? Was it not until GDP had registered moderate growth? He suggested that we were not far away from the threshold whatever that was and that interest-rate inertia was a risk. The public was getting used to low interest rates and to the additional spending power released by the low mortgage rates that accompanied this interest rate structure. He believed that about 40% of mortgage borrowers were on the standard variable rate. His vote was to raise Bank Rate by 25 basis points and he was of the view that it was worth the experiment regarding the impact on the household and corporate sectors. He thought there was a good possibility that bank margins would shrink in such a way as to not be damaged, i.e., for this rate not to be necessarily passed on in full to the private sector. His vote was to hold QE with no bias now to increase.

Comment by John Greenwood

(Invesco Asset Management)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate; no more QE immediately.

Fragile economy and financial sector justify Bank Rate hold

John Greenwood believed that both the real economy and the financial sector performance remained fragile and he believed that there was no persuasive reason to raise interest rates at this time. He drew attention to the premature tightening in Japan in 2000 and the dangers of activating another negative episode of growth from premature tightening. His vote was to keep Bank Rate at its current level. He was concerned about the inadequate pace of domestic monetary growth and would like to see monetary growth back towards a 6% to 8% growth pace. He believed that, whilst he would not vote for more QE at the moment, more QE should be undertaken if the $M4^{ex}$ growth rates remained less than 3%.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate; no more QE immediately.

FSA excesses sapping economic vitality

Ruth Lea was not terribly concerned about inflation and relaxed about the inflation risk associated with the Bank of England's balance sheet. She bemoaned the burden of Financial Services Authority (FSA) regulation and capital requirements, believing these to be a detriment to private sector bank lending and economic vitality. Her vote was for no increase in Bank Rate and for QE to be on hold with a bias to do more conditional on economic weakness.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%.
Bias: No more QE.

Time to move towards a more normal real interest rate

Andrew Lilico argued that it was time for the Bank of England to lead interest rates back towards the natural rate and that there was a justification for this move from the persistence of inflation. Furthermore, there was no justification for leaving rates of this low level on the basis of temporary factors. He stressed the dangers of consumers assuming that emergency rate will be permanent and that this was the time when Bank Rate should be raised. His vote was to raise Bank Rate by 50 basis points straight away. He would retain the existing stock of QE, but with no further increase. Andrew Lilico agreed with Patrick Minford that there was indeed a latent medium-term inflationary danger associated with the QE that had already been done.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼ %.
Bias: Neutral.

Nightmare scenario

Patrick Minford stated that he was concerned about the nightmare scenario where suddenly bank credit could explode and the Bank of England would find it very hard to

reverse engines so his vote would to begin the normalisation of interest rates straightaway with a token increase of ¼% at the May meeting and that QE must end. Indeed, he looked for QE to be withdrawn at the rate of approximately £50 billion a quarter to remove the incendiary material that might otherwise lead us into an inflationary scenario from which policymakers would find it difficult to exit.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate.
Bias: To raise Bank Rate; no additional QE for time being.

Recent recovery in sterling should be welcomed, not attacked with excessive monetary ease

David B. Smith said he was surprised that no-one had mentioned the recent strength of sterling, even if this was partly provoked by developments on the Continent of Europe. He believed that Britain behaved like a small, open trade-dependent economy and that changes in the external value of the currency were the main transmission mechanism through which monetary policy affected the economy. He certainly would not resist a further moderate rise in the external value of the pound, whose earlier depreciation was a leading cause of the inflation overshoot that had reduced living standards, damaged the economy, and undermined the Bank's credibility. A major forecasting uncertainty was how much global spare capacity there really was – in other words, how much of the contraction in global activity since 2008 was permanent and how much was transitory. It was global – as distinct from domestic – spare capacity that was the most relevant consideration for projecting British inflation, because global inflationary trends had a powerful and rapid impact on the UK rate of price increase. The recovery in the UK was not solely dependent on personal and government consumption, as some people had argued. Private investment and stock building would both respond positively to any globally-generated upswing in UK non-oil exports. There was scope to raise Bank Rate for 'normalisation' and signalling purposes but he was a tactical hold this month. This was because of the strength of sterling and the scope for political upsets in the forthcoming French and Greek elections on 6th May, the outcomes of which might really put the cat amongst the Eurozone pigeons. He would hold off any further QE unless the increase in $M4^{ex}$ turned negative again.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%; refocus QE on less liquid assets within existing £325bn limit.
Bias: To raise Bank Rate.

Erroneous belief that Bank Rate should be held

While the UK economy continued to make weak and faltering progress, the presumption that Bank Rate should be held down at the current levels was erroneous, in Peter Warburton's view. The pressures on market interest rates had grown in recent months, reflected in much better offerings to savers during the ISA season and higher standard variable rates by some mortgage providers. It was an open question whether small increases in Bank Rate would trigger a general increase in borrowing costs for the private sector, or whether Bank Rate spreads would absorb the increase. Peter Warburton tended towards the latter opinion. It was time to begin to withdraw the

borrowers' subsidy in favour of savers; to take steps to reactivate the interbank market and to signal the end of emergency low interest rates.

Important IMF research

An important paper by Manmohan Singh and Peter Stella for the International Monetary Fund (IMF), entitled "Money and Collateral" had explained the limitations of a QE policy based solely on the purchase of government debt, which was prime collateral. "To the extent that the central bank merely substitutes central bank money for assets that have retained their value as collateral, not much liquidity relief is attained. In order to provide effective liquidity relief for the system, central bank money and liquid collateral must be injected against illiquid or undesired assets; the *supply of unencumbered collateral has to increase*." Basically, the Bank of England's QE had not loosened the collateral constraints on the commercial banks and hence had not motivated them to expand their private sector lending. Given the many regulatory constraints facing banks, it would require the Bank of England to take more liquidity risk in order to reactivate bank credit and broad money growth. The Bank could increase the effectiveness of its QE policy at the current size by switching its purchases to other, less liquid instruments such as mortgage-backed securities.

Bank should purchase less liquid assets

Peter Warburton's vote was to raise Bank Rate at the May meeting by ¼% with a view to further increases as we gained a better understanding of the current relationship between Bank Rate and the prevailing structure of market interest rates. In addition, the Bank should announce a programme of discounted asset purchases of less liquid assets, financed by sales of gilts.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate and do more QE if money growth slows.

Economy too weak to withstand a rate rise

Trevor Williams believed that the demand situation was such that the economy simply was not strong enough to withstand a rise in the official rate. He believed that consumer confidence and business confidence were still too weak to withstand a rate increase. This meant that his vote was to keep Bank Rate on hold at ½%. He reiterated his concern about the impact of regulatory policy on credit supply but also believed that the underlying demand for bank credit remained weak. He considered that the sustained low level of gilt yields suggested that the market had brought into the coalition's fiscal plans. He was concerned about the international effects on inflation and believed that the UK has become a price taker of global inflation. He would hold QE and if the growth of the money supply were to fall back then he would be willing to do more QE.

Policy response

1. Five SMPC members voted that Bank Rate should be held on 10th May; three wanted to raise it by ¼%, and one member desired a ½% increase.

2. Most of the shadow committee members thought that there should be no additional QE in the very short term, although there was a divergence of view with respect to the appropriate policy subsequently. Some members believed

that further tranches would be required because of the weakness of the economy; others wanted to hold the existing stock, and one member thought that QE should be gradually unwound to avoid longer-term inflation risks.

3. There was a widespread view on the SMPC that the British economy was suffering major supply side difficulties in addition to any possible demand shortfall and that clumsily excessive financial regulation posed a major threat to the real economy, as well as the supplies of money and credit.

4. There was also a strong view that the official ONS data was no longer fit for purpose where the national accounts were concerned, and a further concern that the forecasting frameworks employed by the OBR and the Bank of England were inadequate and likely to produce misleading policy advice.

Date of next meeting

Tuesday, 10th July 2012.

Note to Editors

What is the SMPC?

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

Current SMPC membership

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

For more than twenty years Lombard Street Research has provided many of the world's most influential investment institutions with creative, thoughtful and pertinent macroeconomic analysis and investment advice.

Genuine global-macro thinking drives all of our investment themes. This provides our clients with a fully integrated research input that is essential in the modern investment environment to either maximise returns or minimise risk.

Critical conclusions are expressed in actionable ideas for investors.

Services include:

Strategic Asset Allocation (12 month portfolio calls)

Tactical Asset Allocation (3-9 month trading ideas)

Investment Advisory (consultation on portfolio construction, use of derivatives/hedging)

A worldwide network of offices in London, New York and Hong Kong allows us to provide a global service to a global audience.

London Tel: +44 (0) 20 7246 7850 london@lombardstreetresearch.com

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

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

Lombard Street Research

Independent • Objective • Creative

Pellipar House, 9 Cloak Lane, London EC4R 2RU

www.lombardstreetresearch.com