Lombard Street Research

Shadow Monetary Policy Committee


A FRIEND in Lombard Street.

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IEA's Shadow Monetary Policy Committee votes by six to three to hold Bank Rate in April

In its most recent e-mail poll, completed on 27th March, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that UK Bank Rate should be held at ½% when the official rate setters meet on Thursday 5th April. The three dissenters all wanted to raise Bank Rate by ¼%. In addition, two of the members who voted to hold in April had a bias towards rate increases in the near future. Several of the 'hikers' also had a bias towards further rate increases subsequently. This represented the most hawkish position that the SMPC had adopted for some time. It reflected the views that: 1) money-market rates were so far above Bank Rate that the latter risked irrelevance; 2) some normalisation of Bank Rate up to, say, 2% was appropriate now that conditions had partly stabilized, and 3) the improved euro-zone situation provided a possibly, short-lived window of opportunity to normalise UK borrowing costs.

The predominant reason why most SMPC members voted to hold Bank Rate in April was the view that there remained ample spare resources in the British economy, despite some tentative signs of recovery, together with concern that broad money was still growing too slowly to sustain any upswing. There was a general view that the macro-economic impact of the 21st March Budget was broadly neutral, and did not warrant a change in rates. However, committee members questioned the desirability of adding further complications to a tax system that was already of baroque complexity and needed wholesale simplification and reform instead. There was a further concern that the Chancellor's deficit forecasts were too optimistic and that a future British sovereign debt crisis could not be precluded if fiscal credibility was lost.

The SMPC has gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the deeper issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts exactly nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. This means that the nine SMPC analyses should be regarded as being of more significance 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 next SMPC gathering will take place on Tuesday 17th April and its minutes will be published on Sunday 6th May. The next two SMPC e-mail polls will be released on the Sundays of 3rd June and 1st July, respectively.

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Comment by Tim Congdon

(International Monetary Research)
Vote: Hold Bank Rate.
Bias: To hold, while employing QE to maintain steady monetary growth.

Misguided regulatory attack on banks

The regulatory attack on the UK's banks has been under way for over three years now and has resulted in a radical transformation in their balance-sheet structures. The key policy-making individuals and officials (i.e., the Governor of the Bank of England and the then Chancellor of the Exchequer downwards) did not realise in late 2008 that substantial shrinking of banks' risk assets and massive recapitalisation would lead – if not offset by some other force or forces – to a huge contraction in the quantity of money and, hence, to a very severe recession or even a depression. Am I saying then that the key individuals were, to put it mildly, pretty misguided? Yes, that is exactly what I am saying. They might protest that my argument depends on the validity of the monetary theory of national income determination. So indeed it does. They might go further and claim that the monetary theory of national income determination is controversial. Well, that is their problem. My view remains that they were very misguided. UK officialdom's attempts to force banks to cut the size of the balance sheets by a quarter or a third, in only a few years, has to be condemned as crazy; the equivalent in monetary policy of such historical madness as the Charge of the Light Brigade.

QE has fortuitously offset negative regulatory shock to broad money

In practice, as the recession gathered pace in late 2008 and early 2009, UK officialdom responded not only by slashing short-term interest rates to virtually zero, but also by operations (which became known as 'Quantitative Easing' or 'QE') that had – as an intended direct effect – an increase in the quantity of bank deposits. So the quantity of money did not fall as drastically in 2009 as it would otherwise have done. Macroeconomic conditions were certainly far better by early 2010 than had been expected a year earlier, and remained not too bad in the rest of 2010 and 2011. UK banks now have lower risk assets, and far more cash and government securities, than in mid-2008. These assets are matched on the other side of the balance sheet by roughly the same level of sterling deposits, but higher capital.

January monetary data suggest that QE has boosted broad money but only partially

In late 2011, fears were expressed that the UK economy was about to enter another downturn. The latest data do indeed show that in the closing months of 2011 banks jettisoned a significant quantity of risk assets. Without offsetting action, the quantity of money would almost certainly have dropped. In its wisdom the Monetary Policy Committee (MPC) decided in October to initiate another £75 billion of asset purchases under the QE label. That ought to have resulted – over the next three or four months – in additional bank deposits being created as the Bank of England bought gilts (mostly, although not entirely) from non-banks. The monetary effect of official operations of this sort can be identified in the credit counterpart arithmetic in the category 'public sector contribution to money growth'. The public sector contribution to money growth was high in October itself, but then surprisingly small in November and December. However, we now have the January figure and everything has gone according to plan. The public sector contribution to M4 growth in the four months to January was £53.4 billion, not exactly £75 billion, but allowance needs to be made for purchases from banks, purchases from foreigners, etc.

Small pat on the back

Although banks continued to rid themselves of assets that they deemed non-core, the $M4^{ex}$ money measure rose by 1.9% in January. The three-month annualised rate of growth – which was negative in December – bounced back to a perfectly satisfactory 4.2% in January. Meanwhile the UK's broad money measure remains in positive territory on the annual rate of change, with the January figure being 2.9%. With non-energy prices pressures weak and short-term interest rates at more or less zero, numbers like these are consistent with a general absence of balance-sheet strains throughout the economy. The stock market has indeed had a good start to 2012. Last autumn's QE programme deserves a small pat on the back.

Trigger-happy MPC attitude to QE

But, what happens from here on? The £75billion of QE announced last autumn seems to have been fully justified by the weakness of lending to the private sector, as the banks cut down on assets that they did not really want (or, at any rate, that under regulatory pressure they felt obliged to relinquish). What happens in the spring of 2012 if banks keep on cutting back heavily on their risk assets? The closing months of 2011 saw severe weakness in bank lending to 'intermediate other financial corporations', i.e., the quasi-banks established a few years ago partly as a device to evade regulatory capital ratios. However, lending to genuine non-banks has been growing in the last two or three months at a welcome annualised rate in the low single digits. It is possible that the *total* stock of bank lending to the private sector may contract further in the next few months, as banks make their final effort to comply with the regulatory push for extra safety, higher capital/asset ratios, less inter-bank funding and so on. However, the rate of contraction should be less than in 2011. Meanwhile the MPC has shown itself to be rather trigger-happy with regard to QE. Indeed, two MPC members wanted the present round of QE operations to be £75 billion instead of £50 billion.

Positive, but sluggish, broad money growth ought to be consistent with a satisfactory macroeconomic outcome this year

A reasonable central view is that broad money will grow in 2012 even on present policies (i.e., without extra QE), although not rapidly. No doubt banks want to expand their balance sheets again, not least because of the endless (if rather silly) barracking they receive in the media for not doing enough new lending. The money growth rates seen in the mid-noughties (of 10% a year or more) are not on the horizon, but in 2012 the UK could enjoy broad money growth of 3% to 5% a year, the highest rate for five years. An annual growth rate of 3% to 5% in $M4^{ex}$ balances (i.e., in the money balances of the non-bank private sector) ought to be consistent – given the current low inflation and zero interest rates – with satisfactory or even very satisfactory macroeconomic outcomes. My corresponding policy preference is for Bank Rate to stay at ½% and for the Bank of England to vary the quantity of QE in order to sustain $M4^{ex}$ growth in the mid-single digits, at an annualised rate. For the first time since early 2008, it is conceivable that my bias in, say, early 2013 will be to tighten. Nevertheless, and for the moment, my bias is 'no change'.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: To expand QE if situation deteriorates once again.

Almost unprecedented public spending tightening now being attempted

Despite much fanfare and media hysteria, the Budget has done little to alter the macroeconomic outlook. There was plenty of micro-tinkering but no change in the Coalition government's overall fiscal strategy. By the end of this parliament, the government plans to have cut real departmental spending (broadly speaking, total managed expenditure net of social security payments, debt interest and other transfer payments) back to fiscal 2003-04 levels. Between 2009-10 and 2016-17, the expected annual average reduction is 2.9%. This is the tightest spending settlement in the post-war period by some margin. The only comparable period of real-terms cuts in departmental spending was 1974-75 to 1988-89. Over these fourteen years, real departmental spending was cut by 1.5% per annum on average. The current consolidation effort is almost identical in overall size – at least, in terms of departmental spending – but will progress at twice the rate.

But is it administratively feasible?

Whether this is administratively feasible, economically desirable or politically achievable remains to be seen – history does not suggest departmental spending cuts on this scale can be achieved over such a short time-frame. Moreover, and in a world of excessively leveraged private sector balance sheets, the scope for monetary and debt management policy to offset the short-term growth effects of fiscal deflation is more limited than in a normal business cycle. However, it is absolutely right for the government to be talking tough – the UK remains an improbable 'safe-haven' in part because of the credibility the government had earned in the markets. The other half of this grand bargain is easy monetary policy. While the government gets its house in order, the Bank of England must limit the pace of private sector deleveraging, and ensuing monetary destruction, by keeping short rates at their effective zero bound and injecting money directly into the private sector via QE.

Monetary policy risks

This is the correct orientation for macroeconomic policy; but it is not without its dangers. For one thing, it is delaying the necessary repair of private sector balance sheets, what Sir Mervyn King has called the 'paradox of policy'. More importantly, it potentially endangers the credibility of the central bank – Bank of England asset purchases will only continue to stimulate asset prices and economic activity as long as markets remain convinced of the central bank's anti-inflation resolve.

Debate on desirability of QE

There has been much discussion about the desirability of QE, both in the media and amongst academics. Recently, hostility towards the policy has been growing. Even on the MPC there are concerns about inflation expectations becoming dislodged. However, the evidence for this is scant, not least in financial markets where five-year forward inflation breakeven rates are below their five-year average. There remains a strong case for continuing to use central bank asset purchases as a means of lowering longer-term interest rates and boosting the supply of broad money. The key judgement is whether the outlook warrants additional QE at this stage.

Capacity and productivity uncertainties

Inflation is falling back from its recent high point as expected; whether it continues to do so is less obvious. There is a clear upside risk to inflation in the near-term from further disruption to oil supply and the possibility of war in the Middle East. There is also some debate about exactly how much spare capacity there is in the economy and its downward impact on price pressures. On the latter issue, it seems hard to believe that there is not a considerable amount of underutilised resources, especially in the labour market. While the financial crisis will have trimmed the economy's supply potential, the degree of damage implied by many output gap estimates is implausibly large. The OBR, for instance, has argued that output per hour was only 0.4% below its trend level. With output per hour still 1.1% below its pre-crisis peak, this implies a permanent hit to labour productivity of 10% when compared to a continuation of the 1995 to 2005 trend. Even if it is accepted that excessive borrowing inflated pre-crisis productivity, there is no evidence that there has been a massive deterioration in Britain's capital stock or a collapse in total factor productivity. Both the data on wage growth and economy-wide prices (e.g., the gross value added deflator) are consistent with plenty of spare resources bearing down on inflationary pressures. Notwithstanding the downward pressure on money demand from record low policy rates and QE, the recent growth in UK broad money is, if anything, still suggestive of inflation settling slightly below its 2% target.

Further monetary support may be needed

While there is no need to alter the stance of policy at this month's meeting, the likelihood is that further monetary support will be needed. Despite tentative signs of life in the US economy, the global backdrop to the largest post-war fiscal tightening in Britain is pretty grim. Emerging world growth is slowing after monetary tightening last year. In Europe, the crisis is far from over, even if Mr. Draghi has bought some time. UK output growth is likely to be below historical norms until 2014 at the earliest; growth risks are very much skewed to the downside. The same is true of inflation over the medium-term. This alone would justify an easing bias. Were monetary policy being set on the basis of both monetary and financial stability, that bias would be even stronger.

Comment by Anthony J Evans

(ESCAP Europe)
Vote: Raise Bank Rate by ¼%.
Bias: To raise Bank Rate further but keep lender of last resort facilities on standby in case market conditions deteriorate.

Risks arising from unduly low interest rates

Most economists seem to accept that low interest rates contributed to the causes of the financial crisis, and that at some future point they need to return to more normal levels. The debate is therefore about how soon, and how quickly, they should rise. While the costs of raising too early are well known, it is important to also consider the ongoing costs of low interest rates. Foremost among these are the adverse impact on people on fixed incomes. However, it would be interesting to see more research on the welfare costs of QE given that low gilt yields have also led to high asset prices meaning that for many savers the impact is ambiguous. The Bank for International Settlements (BIS) also points out that low interest rates are delaying balance sheet adjustments and magnifying the credit risks that arose ahead of the crisis. An even less understood cost is the fact that low interest rates send false signals to the market and generate mis-allocations of capital. The longer that interest rates remain artificially low, the more likely that the public use them as a benchmark for what is considered normal. UK households are spending 25% of disposable income on debt repayments, and the low rates available for tracker mortgages entices borrowers to become susceptible to rate rises. Standard variable rates have already begun to rise and further rises need to form part of the expectations of current borrowers. A moderate raise in Bank Rate would serve as a useful warning about the future path of interest rates.

Inflation remains above target

We should not forget that the MPC's primary aim it to deliver low inflation. Although the rate of Consumer Price Index (CPI) growth is lower than it has been in recent months (down from 3.6% in January to 3.4% in February), this should not be a distraction from the fact that it has been above target for more than two full years. Medium-term inflation expectations may be considered a better focus of policy than historical figures, but there is evidence that this is creeping up. As February's *Inflation Report* points out, households inflation expectations are 'elevated' and other forecaster's probability distributions for CPI inflation show that from 2013-2015 the probability of below target inflation is falling, whilst the probability of above target inflation is rising. $M4^{ex}$ broad money continues to grow at a moderate rate and has recovered from the lull that occurred in December 2011.

Problems on the supply side

The policy response of low interest rates and QE have had time to work but the more time that passes the less likely that the economy will respond to aggregate demand stimulus. In short, and if the aim is to boost nominal GDP, it becomes increasingly likely that we will see inflation rather than increases in real output, suggesting that the economy is facing a supply side problem. Given the extent of inefficient labour market regulations, punitive tax rates on middle and high rate earners, an ongoing skills shortage – and the fact that the recent Budget did little to affect the long-term trajectory of these issues – sluggish growth is perhaps the best we can hope for. A lot of the household 'wealth' that appeared to evaporate during the crisis might best be viewed as a permanent decline in consumer spending as opposed to an output gap that may be regained. Productivity figures back this up.

Alternatives to QE

It would be wrong to be blasé about the downside risks facing the UK economy, and fears that excessive monetary stimulus will lead to uncontrollable inflation have consistently failed to materialise. However, low interest rates and QE were adopted on emergency grounds and the goalposts as to when this emergency is over continue to shift. If the first quarter growth figures show that the UK is back in recession, this may justify keeping interest rates on hold. However, most forecasters expect growth to return. The risks to the UK economy posed by a

Greek default and a disorderly breakup of the Euro have diminished, and those of us who advocated keeping interest rates low to see how the February/March restructuring would play out should now accept that it is time to move forward. Of course, conditions in the euro-zone may worsen, and the threat of further sovereign debt crises remains. However, this will always be the case. The Bank of England must be alert to a possible spike in the demand for money but this should not preclude a moderate raise in Bank Rate.

Comment by Ruth Lea

(Arbuthnot Banking Group)
Vote: Hold Bank Rate.
Bias: To hold Bank Rate (no bias); no more QE and no bias regarding future QE.

No significant Budget surprises

The Budget contained no significant surprises, mainly because the policy changes had been so comprehensively leaked. Nevertheless, the acceleration in the cuts in the Corporation Tax Rate, down to 22% by 2014/15 and with an aspiration to reach 20%, was helpful to business. In addition, the reduction in the higher rate of tax, albeit to 45 pence and in April 2013, gives a much needed fillip to retaining internationally mobile senior staff, not least of all in the City. Even though these policy changes will not transform Britain's economic outlook overnight, they are undoubtedly a step in the right direction.

Prospects have improved but euro-zone measures have only papered over the cracks

The March 2012 forecasts from the Office for Budget Responsibility (OBR) were a tad brighter than those released last November. The economic mood has lightened since then reflecting brighter prospects in the USA and a deceptive lessening of tensions within the euro-zone, engineered by the activist European Central Bank (ECB) and an apparently successful conclusion to the negotiations over Greece's second bailout. Nevertheless, with many euro-zone economies stumbling further into recession, it is all but inevitable that the euro-zone 'crisis' will blow up again at some stage. Sanity will only prevail in this beleaguered currency bloc when it is reconfigured and the weaker countries leave and are free to pursue expansionary policies. As far as timing is concerned, I am with Macbeth: "…if it were done when 'tis done, then 'twere well it were done quickly." Unfortunately, it probably will not be.

UK inflation outlook has worsened, partly as a result of high oil prices

Despite the falls in CPI inflation in recent months – it was 3.4% in February – the underlying inflationary outlook has worsened since the turn of the year as continuing tensions in the Middle East have driven oil prices up to record highs in sterling terms. The Bank's projection in the February *Inflation Report* that CPI inflation would be down to the 2% target by the end of 2012 looks optimistic – though much will depend on the trajectory for oil prices. This doubt was endorsed recently by Spencer Dale who warned that inflation could indeed turn slightly higher than the Bank's projection this year and next. The MPC's March Minutes also noted that "seasonally adjusted monthly inflation rates had remained somewhat higher than the inflation target". The Minutes also contained a discussion on domestically-generated inflation, focussing on wage costs. They noted that, even though the annual total earnings growth was just 2% in 2011 Q4, there were "some early indications that private sector wage settlements had picked up at the beginning of the year". The latest survey by Income Data Services did indeed suggest that average pay deals had risen to 3% in the three months to January compared with 2.5% in the previous three months.

Money supply picked up in January but high bank funding costs are being passed on

Money supply growth recovered strongly in January, probably reflecting an unwinding of exceptional year-end balance sheet effects. However, higher bank funding costs are also being passed onto borrowers. Halifax for example recently raised its standard variable rate by nearly 0.5%. There was no major fiscal stimulus announced in the Budget – overall it was fiscally neutral over the forecast period. Furthermore, and given the absence of effective supply-side policies, the Government still seems to be relying on the Bank to provide much of the economic stimulus. The MPC has obliged by sanctioning a very accommodative monetary policy. It should continue to do so. Despite signs that wage settlements are ticking up, there is no need for any change at the moment.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate by ¼% and do no more QE for now.
Bias: To raise Bank Rate fairly continuously up to 2%, before a pause to review.

Brief window of opportunity to raise Bank Rate

With the euro-zone crisis temporarily off the boil, there is a brief window of opportunity for the Bank of England to raise rates. It should seize it. It is well behind the curve on raising rates. The economy is increasingly at risk of a lasting dependency on emergency rate levels. However, the emergency has long since passed, and the economy is now in a sustained period of working through its debt problems. Rates should be raised, not yet to their natural rate (which may have fallen significantly, perhaps to as low as 3%) but at least to a level at which Bank Rate reconnects to the wider monetary transmission mechanism and makes it more credible for banks to seek to fund themselves via deposits. This implies a Bank Rate of around 1.5% to 2%.

Mortgage rates are rising and some borrowers will default

Even such a modest rise may drive some households into mortgage default. Some estimates suggest that even millions of households could be placed in distress by a 2% rise in mortgage rates. However, those on tracker mortgages linked directly to Bank Rate have tended to be significant gainers from emergency rate levels. And, to be blunt, if your mortgage has been 0.99% for the past three years and you have not been able to pay down some of your debt, monetary policy is unlikely to be able to save you from here on, even if doing so were morally justified (which it is not). For those on more standard mortgage packages, interest rates have already started to rise, reflecting regulatory requirements, increasing default risk, and funding costs. One way or another, mortgage rates are going up. Those mortgagees who have failed to make their finances more sustainable over the past three years are going to default. Policy makers can (and should) delay this only for so long.

Regulatory pressures on money creation

It is, of course, the case that there are other, regulatory pressures on the money supply, created by misguided notions of increasing capital requirements. There is, again, only so much monetary policy can do to offset such huge policy errors elsewhere and only so long that monetary policy is justified in attempting this.

Further downgrades to Britain's sustainable growth rate

Accompanying the Budget, the OBR downgraded its estimate of the sustainable growth rate for the UK yet again – now to just 0.8%. That means that, in the OBR's view, the years 2011 and 2012 are not slow-growth years, but instead years in which the economy grew fairly close to its potential. In that context, there is less and less justification for monetary policy to be providing extreme stimulus. The only consequences of maintaining rates so far below the natural rate of interest are: (a) increased inflationary pressure; and (b) mal-investment, induced by artificially low rates. Whether inflationary pressure is realised into inflation in the short-term will depend on how quickly mal-investment is exposed as such. There is every prospect that, in fact, mal-investment will be sufficiently serious that its purging in recession will come ahead of inflationary pressures, so that mal-investment-induced recession beats inflation to the punch, and the first recession we get comes before the high inflation. However, if it does not – and if the economy does start to recover – we can expect inflationary pressures and a need for a, perhaps, steep rise in interest rates to combat inflation, inducing recession either way. The experience of the past five years suggests that if the UK economy is not actually contracting, then inflation rises towards 5%. We shall be lucky if the peak is as low as that the next time. Raising interest rates a little would provide a signal to households that they needed to panic more and, deleverage faster. That would be healthy. If household debt reduces and Bank Rate rises a little closer to the natural rate of interest, then the economy's rate of growth in potential output will rise and the chances of being able to service our debts over the medium term without resorting to inflation will be improved. We do not need a large spike in interest rates, but it is past time for a tweak. A signal is needed that emergency rates will not be sustained indefinitely.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼%.
Bias: To raise Bank Rate and halt and then withdraw QE.

Fundamental Budget plan is correct

The fundamental Budget plan is correct: to cut spending steadily and raise taxes as needed across a broad tax base, until the government's debt ratio to GDP is stabilised and brought back down towards a less dangerous level of below 60%. The problem has been the lack of policies so far to cut taxes that deter the growth of enterprise. In this year's Budget the Chancellor, George Osborne, made a start in addressing this problem. However, it is never easy to reform tax when there is no spare money to buy out losers. This is the situation today. So George Osborne is to be congratulated on making some progress in changing the tax system in beneficial ways.

Reduction in the 50p rate was justified

First, he managed to cut the damaging 50 pence top tax rate, which HMRC confirmed was raising virtually no revenue. These calculations are tricky since they depend on assumptions about responses to alternative tax structures. However, based on previous work for the UK, it seems most likely that the 50 pence rate reduced tax revenue because of evasion and negative supply responses, either through net emigration or by reduced labour supply. HMRC's assumptions were cautious and so found less dramatic effects. However, the tax is damaging activity as well. Indeed, that is how the revenue loss comes about, via a lowering of the tax base, offsetting any gain from the higher tax rate. So, when that is put into the equation, it is ludicrous to raise such a small amount of revenue from better-off people in this way. The 45 pence rate remains too high. Nevertheless, the cut is important as a signal of the priorities being given to incentives for business and business people. Presumably, it will be followed by further reform, or so we are being led to expect.

Welcome cut in corporation tax

Second, there was an added 1% cut in corporation tax, with an eventual move to 22 pence; capital allowances are somewhat reduced. This is again very welcome. Capital allowances distort investment decisions towards greater capital-intensiveness; while leaving the marginal tax rate on new profitable projects unaffected, since at the margin the extra activity or business expansion may not use these allowances. Cutting corporation tax does cut this marginal tax rate and so encourages expansion.

Raising personal allowance has distorted structure of marginal tax rates

Further budget tax cuts come from raising personal allowances to £9,000, which is a Liberal-Democrat priority. It is not really a good idea when one considers it against the yardstick of marginal tax rates. The best schedule of marginal tax rates is flat; a higher personal tax allowance creates a bigger band where it is zero which has to be paid for by higher marginal rates of tax elsewhere. 'Taking people out of tax' sounds attractive administratively. Nevertheless, it is something of an illusion because many of the people 'taken out' go back in for tax credits and welfare benefits. Furthermore, the costly rise in the allowance is balanced by extra taxes of various sorts: the extra 7% stamp duty band on properties over £2 million is the main one. Another is the freezing of the allowances for pensioners and higher rate bands. On marginal tax rate grounds, this whole package is poor. Stamp duty in particular is a tax that damages mobility and should in any case be repealed in favour of a proper consumption tax on the imputed rent of owner-occupied housing. However, it is mandated by the politics of the coalition and as tax goes is relatively harmless. There has been a big fuss about the freezing of the pensioner allowance. However, in the context of the full indexation of pensions themselves over the last few years when real wages for other groups fell dramatically, the retired have not been badly treated.

More upbeat economic news

The latest news from the economy has been more upbeat, with purchasing surveys suggesting revival, much as they are in the US. The Osborne budget should add to business confidence. With the euro-zone crisis currently relegated to the backburner as a result of the ECB's 1 trillion euro injection of liquidity into the banking system, it should now be possible for the Bank of England to focus on getting interest rates up and unwinding its dangerously high holdings of UK government debt particularly as the news from the inflation front is ominous once more. Because it has refused to take any action to bring down inflation, the Bank has made itself vulnerable to a further dose of commodity inflation, which is now duly occurring, with both oil and food prices rising substantially. Once more this year, the Bank looks likely to seriously overshoot its inflation forecast, not to speak of its inflation target.

Time for a rate rise

In these circumstances, I recommend a small rise in interest rates, of ¼%, with a bias to raise in future; and also a cancellation of the latest QE proposal of £50 billion, with a bias to unwind QE by £50 billion per quarter for the next year. If the Bank is serious about attacking the structural malaise in banking that is in turn sabotaging the growth of Small- and Medium-sized Enterprises (SME's), then it should match the Chancellor's overtures to business with its own overtures to bankers. It should start to put its weight behind banking deregulation and the reduction of banking costs; it should reverse the regulative overkill that UK bureaucracy has indulged in. This would complement the return to monetary orthodoxy recommended above.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)
Vote: Hold Bank Rate.
Bias: To raise Bank Rate; QE in reserve for lender of last resort purposes.

The 2012 Budget did no serious damage

The first comment on the 21st March Budget is that at least it did no major new damage to the UK economy. This contrasts with Mr Osborne's previous misguided decisions to raise Value Added Tax and employer's National Insurance Contributions, which hit the nascent economic recovery on the head, reduced output and employment, and made the public finances worse not better. That having been said, it was also a curiously 'Brownite' budget in two distinct senses. First, there was a lot of needless, politically-motivated tinkering with a tax system which is already massively over-complex and desperately needs simplification and reform. Second, there was a strong reliance on Gordon Brown's old friend Rosy Scenario, and 'jam tomorrow but never today' where the budget deficit is concerned. Mr Osborne's 'narrative' – in a spin doctor's sense – was also interesting. At some points, he seemed on the verge of making the intellectual case for a less interventionist more pro-business approach (as represented on *The Economist* magazine's amusing cover for its 24th-30th March edition). However, at other points he seemed to be playing the class-warfare card and revelling in it.

Need for a pro-market narrative

The Labour opposition now has a simple spin-doctor's 'narrative'. The recession was nothing to do with their own earlier policies in office; the blame lies entirely with the feckless behaviour of the rich; the country is stuck with the adverse consequences, and all that can be done is to share out the misery as fairly as possible. The Chancellor's should have argued that the economic misery was the result of policy blunders in the area of financial regulation and monetary policy as well as fiscal overstretch by the previous government, the misery was not inevitable but could be reversed, and the way to do so was by unleashing the wealth creating powers of liberal-market capitalism. Sticking one's head over the parapet may be too much to ask when the cabinet is made up largely of gilded 'wealth conservators' rather than self-made entrepreneurs. However, the default position that has gone unchallenged for too long in the UK political debate is that there are only two morally legitimate sources of income. One is living off the state, which appears to be the position adopted by Labour and Liberal-Democrats and also the BBC. The other politically-acceptable route to income appears to be via inheritance, which seems to be the, not necessarily conscious, attitude of the 'Cameroons'.

Possible over-optimistic assumptions on public spending

A society which treats wealth creators badly is not likely to have much wealth generated, especially if the smaller entrepreneurs – who create most new jobs – have to divert their energies to coping with a highly complex tax system and a spider's web of labour market regulation. Mr Osborne's medium-term projections have economic growth picking up to 3% in the final years of his forecasting horizon 2015 and 2016. However, the supply-side policies implemented so far have been too timorous and modest for this to be achievable. At the same time, the forecast in the OBR's post-Budget *Economic and Fiscal Outlook* that the cash value of general government expenditure on goods and services would only rise from £348.2bn in 2012-13 to £348.4bn in 2016-17 is eyebrow-raising, to say the least, as is the prediction that the cash value of general government gross capital formation will only increase from £30.6bn in 2012-12 to £31.2bn in 2016-17. The volume of general government consumption is officially predicted to be 9.9% lower in 2017 Q1, when the official forecasts end, than it was in 2011 Q4 (the last published data point) while the volume of government capital formation is predicted to drop by 1.3% over this period. It is also significant that the household consumption deflator is predicted to go up by 14.5% between 2011 Q4 and 2017 Q1, while the cost of general government current expenditure is expected to rise by 11.1% and that of government investment by 1.3%. Normally, government consumption costs grow by some 1% to 1¼% more each year than the inflation rate of household consumption. Mr Osborne's projections rely on a noticeable squeeze on public sector costs, as well as real 'cuts'.

Post-Budget growth forecasts

Unfortunately, there are now few independent macroeconomic models available to provide an independent assessment of the OBR forecasts. The situation has been worsened by the chaotic and delayed introduction of the new ESA 2010 national accounts, which means that most forecasters have little faith in the reliability of the official statistics that they are including in their models. However, the Beacon Economic Forecasting (BEF) macroeconomic model has recently been re-estimated using the new ESA 2010 data and has been run to incorporate the Budget measures. The post-Budget BEF projections show UK growth averaging 1.1% this year (compared with an OBR forecast of 0.8%), 2.8% next year (OBR 2.0%), 2.4% in 2014 (OBR 2.7%), and 2.7% in 2015 and 2016 (OBR 3% for both years). The BEF's relative optimism on short-term growth partly reflects the absence of further harmful tax shocks – the BEF model has moderately powerful supply-side effects incorporated in it – and also the scope for a recovery in world trade which should help UK export volumes, if it transpires. With limited room for household consumption growth, the UK outlook is now highly dependent on the strength of non-oil exports; especially as much domestic capital formation is undertaken to help supply overseas markets, not domestic ones.

Inflation, unemployment and trade

Unlike the official forecasts, which simply assume that the official 2% CPI target is met in the outer years, the BEF forecasts show something of a 'U'-shaped pattern with annual CPI inflation falling to 2.1% in the final quarter of this year before rising to 2.8% in 2013 Q4 and a target-busting 3.9% in 2014 Q4. This pattern is heavily dependent on wider international price trends, including those in the prices of oil and non-oil commodities, and also to the external value of sterling. The OBR expects the pound to be broadly flat at around 81 (January 2005=100) on the Bank of England sterling index. However, it is expected to follow a broadly depreciating path in the BEF projections. This means that UK inflation will exceed that in the OECD area as a whole. However, OECD inflation is itself expected to pick up over the next few years as the international output gap narrows and the lagged effects of recent extreme monetary stimuli work through to the price level. The downward trend in claimant unemployment shown by the OBR from 1.65 million in 2012 to 1.19 million in 2016 is broadly compatible with the BEF forecasts, which show a decline from 1.625 million to1.253 million. There also seems scope for an export led improvement in the balance of payments deficit over the next half decade, albeit the improvement is noticeably less marked in the BEF forecasts than the OBR ones.

Public borrowing likely to overshoot

Despite their relatively more optimistic short-term growth forecasts, the latest BEF forecasts do not show public borrowing coming down at anything like the pace set out in the 21st March Budget projections, however. This is despite the fact that the official forecasts for the volumes of general government consumption and capital formation have been incorporated into the BEF predictions. The borrowing overshoots that emerge do so for three main reasons. First, the costs of government spending are set endogenously and overshoot the OBR forecasts. Second, the non-socialised sector of the economy now appears too small to sustain the flow of non-oil taxes projected by the OBR. Finally, the official projections for a number of other government spending items are lower than the BEF model is projecting. This includes welfare payments and debt interest. The upshot is that the BEF predictions show public sector net borrowing (PSNB) dropping from £126 billion in fiscal 2011-12 to not quite £109 billion in 2012-13 – when the OBR anticipates a deficit of £92bn – before rising to nearly £126 billion in 2013-14 (OBR forecast £98 billion) and then easing to £110bn in 2014-15 (OBR £75 billion), £81bn in 2015-16 (OBR £52 billion) and £43.5 billion in 2016-17 (OBR £21 billion). The PSNB figure for 2012-13 has been distorted by the government's takeover of responsibility for the Post Office Pension Fund. This has had the side effect of reducing reported borrowing by £28 billion in the present financial year and explains the deterioration between 2012-13 and 2013-14. The longer-term risk remains that it will be impossible to avoid a British sovereign debt crisis indefinitely, if further public borrowing overshoots undermine the Chancellor's credibility in the financial markets.

Monetary policy recommendation

Nothing has been said about monetary policy so far. However, monetary policy predominantly remains more of the same for the time being. It is arguably inappropriate to raise Bank Rate immediately after a Budget because of the implied criticism entailed. However, some normalisation of rates will be appropriate in the near future, particularly as Bank Rate is so far below the rates at which commercial banks can raise funds in the money markets that it risks irrelevance. There has also probably been enough QE for the time being. Any future tranches of QE should only be considered if broad money growth threatens to turn negative or there is a renewed financial crisis which requires the Bank to act as a lender of last resort. Bank Rate should be held in April, but with a strong bias to raise rates thereafter. Furthermore, there should be no additional QE for the time being.

Comment by Peter Warburton

Economic Perspectives Ltd)
Vote: Hold Bank Rate, with no extension of QE.
Bias: To raise Bank Rate.

Damage to monetary sector is being repaired

Over the past few months, there have been several indications that the structural damage to the UK monetary sector is repairing. Regarding M4 lending, the three-month annualised growth rate in the measure that excludes intermediate other financial corporations (OFCs) has lifted from *minus* 6.4% last September to *plus* 4.2% in January. Gross mortgage lending in the three months to January 2012 was up by 6.6% on the previous three months and 13.4% higher on the year. The total mortgage stock is rising at a 1.3% annualised three-monthly pace, up from zero very recently. Banks and building societies wrote off £15.3 billion last year, down 12% from two years ago and 9% from last year. Write-offs in the fourth quarter of 2011 were 23% lower than a year earlier. Regarding the M4 money stock, excluding intermediate OFCs, the annual growth rate in January was 2.9% as compared to 1.6% last March. The deposits of the household sector grew by 2.8% in the year to January, up from 1.8% in June; deposits of private non-financial corporations decreased by 1.3% in the year to August 2011 but were 3.8% higher in January, year-on-year. Competition for retail savings has improved; the average interest rate paid on time deposits is now 1.23% as compared to 0.83% in August.

No justification for further QE but inter-bank market needs to be revived

These encouraging developments signal that the Bank of England's *de facto* credit tightening of 2010 and 2011 has ended and that the resumption of gilt purchases by the Bank has begun to have an impact on the broad monetary aggregates. However, the strategy of purchasing gilts at their lowest yields (highest prices) in living memory is already looking shaky as government bond markets have begun to surrender some of their extraordinary price gains of last summer. There is no justification for extending the QE programme. However, The Bank's reluctance to take steps to revive the wholesale funding markets, including securitisations, is holding back the healing of the monetary system. Commercial banks can never revert to a purely customer-deposit funding model, but their willingness to extend credit continues to be tightly constrained by the lack of funding liquidity. If the interbank market is broken beyond repair, then a substitute (collateralised) market is urgently required to take its place. The revival of the interbank and securitisation markets, through which monetary policy formerly operated, is vitiated by near-zero interest rates.

Continuing fiscal and inflation pressures on household budgets

The March Budget lays some better foundations for a consumer recovery during 2013, but another year of heavy lifting lies ahead for the household sector. Job shedding in the public sector has occurred more rapidly than expected while the loss of economic momentum last year has damaged opportunities for household income growth in the private sector. Past and present Budget changes to income tax and National Insurance payments imply a further increase in the household tax burden for 2012-13. The inflation optimism of the Office for Budget Responsibility and the Bank of England's Monetary Policy Committee for 2012-13 is poorly founded and hence real disposable income is not expected to register an annual gain this year.

Bizarre OBR forecasts

Bizarrely, the OBR has upgraded its consumer spending outlook for 2012, relative to last November, while downgrading its business investment projections. The stated justification for the stronger household consumption forecast was that the receipt of windfall gains from the mis-selling of payment protection insurance (PPI) are more likely to be saved than spent. About £2 billion of compensation was paid in 2011, with a further £6 billion set aside by UK banks. However, the recent experience of one-off income supplements suggests that the saved proportion will be quite high. Set against the expansionary PPI effect is the adverse impact from increases in mortgage interest rates. The average standard variable rate (SVR), now paid by more than half of all mortgagees, has drifted up to 4.17% in February from 3.98% last May. Halifax, Royal Bank of Scotland and Santander have recently announced rate increases from previously attractive levels that will lift the average SVR even higher.

Bank Rate needs to be re-connected with market rates

Sluggish private sector loan growth and weak transmission of negative real interest rates to the real economy remain key impediments to a more vigorous UK recovery. Hence, this is not the moment to raise Bank Rate. However, the reconnection of Bank Rate with the market interest rate structure cannot be postponed indefinitely. A token Bank Rate increase should be pencilled in for later on in the present year.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold Bank Rate and maintain QE.
Bias: To ease via QE if broad money growth slows.

Budget maintained the fiscal course set out after 2010 election

The 21st March UK Budget did not deviate from the task set out in the very first Budget under Chancellor Osborne in June 2010, and reiterated at the start of his speech, to get the Budget deficit down to manageable levels within five years. This meant that what he gave with one hand he took away with the other, so that there was no net real change in either the path, or the level, of the budget deficit and debt. By 2015/16, the budget deficit is expected to be back in surplus after taking account of the economic cycle, which is in line with the projections made in the 2011 Autumn Statement. In short, this was a 'fiscally neutral' Budget and so contained no net tax give-away over the forecast horizon. Real cuts in spending are scheduled for the remainder of this Parliament and beyond. To be sure, with borrowing in fiscal 2011-12 now projected to have been £126bn or 8.3% of GDP, the Chancellor had little choice in the matter. With the UK on negative watch from some rating agencies, a net tax give-away or radical Budget was clearly judged too risky and the need to retain Britain's 'safe haven' status too urgent.

Significant Budget changes

Yet, there were some significant changes announced. Most were widely discussed ahead of the Budget, including a rise in the personal tax allowance and a cut in the corporation tax rate to 24%, with the promise of further reductions to 22% by fiscal year 2014/15 and thence to 20%. These were paid for by a rise in stamp duty, to 7% for properties over £2 million; cuts in the income tax threshold for basic rate and upper rate tax payers; a reduction in age-related allowances and a crackdown on tax avoidance. The latter includes a 15% stamp duty on people buying properties through overseas companies.

Medium-term Budget growth projections seem over optimistic

Also helping to pay for the give-aways, was a rise in the bank levy, so that the net take for the Exchequer remained at around £2.5 billion. There were efforts to help growth. However, these measures added up to very little in total and are unlikely to boost the economy. In this regard, therefore, it is no surprise that the economic assumptions for 2012 and 2013 are roughly unchanged at 0.8% and 2% growth, respectively. Further out, the OBR assumption remains at 3% for economic growth in 2015 and 2016, which seems somewhat optimistic compared to independent forecasts. Risk to 2012 and 2013 remain significant, especially from Europe and higher oil prices. All in all, this was a Budget that was steady as you go, which suggests that the perception of the UK as a safe haven remains intact for now.

Monetary policy should remain loose to offset fiscal tightening now under way

There should be little implication of any policy reaction in light of the unchanged growth figures. There was also an acknowledgment that inflation will average 2.8% this year. On the surface, this is higher than the Bank of England assumption. For now, the bias for monetary policy should be to keep Bank Rate at the three year low of 0.5%, and to maintain QE for the time being. This is to help offset the fiscal tightening underway and to keep money supply growth positive in face of the regulatory restraints and the risks from private sector and bank balance sheet reduction this implies.

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), Gordon Pepper (Lombard Street Research and Cass Business School), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds TSB Corporate Markets). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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