Shadow Monetary Policy Committee

February 2012



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

Following its most recent quarterly gathering on 17th January, the Shadow Monetary Policy Committee (SMPC) voted unanimously that UK Bank Rate should be held at ½% on Thursday 9th February. The main reason why SMPC members again voted without any dissension to hold the official interest rate in February was their concern about the potential adverse consequences of the crisis in the euro-zone for UK banks and exporters. Indeed, more time was devoted to a discussion of the situation in the euro-zone at the SMPC meeting than it was to British policy issues. The general view was that the UK monetary authorities were in the position of doctors attempting to treat a patient with a life threatening medical condition that was incapable of diagnosis. Any aggressive treatment was more likely to prove fatal than to provide a cure. However, relying on a spontaneous recovery did not necessarily provide much hope either.

Two things that the SMPC generally agreed on were that a Greek default was unlikely to be averted and that there was a serious inconsistency in British monetary policy between the official hard-line approach to financial regulation and the need to maintain the supplies of money and credit to the private sector in order to sustain job-creating activity and the tax base. The official intention to raise bank capital and liquidity requirements represented a perverse, business-cycle exacerbating, regulatory shock. The UK monetary authorities would be better advised to re-instate the Special Liquidity Scheme, whose premature withdrawal had badly damaged the credit creation process, if they wanted to succour Britain's economic recovery.

The SMPC itself is a group of economists who have gathered quarterly at the Institute of Economic Affairs (IEA) since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the deeper issues involved, distinguishes the SMPC from the similar exercises carried out by a number of publications. Because the committee casts exactly nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a consequence, the nine independent SMPC analyses should be regarded as being 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 shadow committee 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 4th March and 1st April, respectively.

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Minutes at the meeting of 17th January 2012

Attendance: Philip Booth (IEA-Observer), Roger Bootle, Jamie Dannhauser, Anthony J Evans, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David B Smith (Chairman), Akos Valentinyi, Peter Warburton, Trevor Williams.

Apologies: Tim Congdon, John Greenwood, Ruth Lea, David H Smith (*Sunday Times* observer), Mike Wickens.

Chairman's Comment

Thank you to Gordon Pepper

The Chairman started by saying that Gordon Pepper had confirmed his intention to stand down from the SMPC in January 2012 in order to make way for the new younger members of the committee who had recently been recruited. The Chairman expressed his sincere thanks to Gordon Pepper for his consistent loyal service to the SMPC since its foundation in July 1997. He added that Gordon Pepper would be remembered among his numerous other contributions for his pioneering advocacy of Quantitative Easing (QE) where he was well ahead of the consensus and the Bank of England in understanding the need for such measures. The Chairman then called upon Trevor Williams to give his assessment of the global and domestic monetary situation.

UK Economic Situation

Weak global growth in 2011

Trevor Williams said that he would reverse the usual order and discuss the domestic monetary situation first and then go on to analyse the global scene. He referred to his prepared charts on the monetary situation. The domestic scene was set by events that had weakened global growth in 2011. The euro-zone crisis, the deepening credit crunch, faltering trade and confidence effects were joined by spending cuts in the US, tightened monetary policy in the emerging economies and continued rising oil and commodity prices. The present year had started with weak growth compounded by political risks from the Middle East, regulatory risks for banks in advanced economies, and sovereign risk and bank default risk. The only positive sign was the overweight holdings of cash on the balance sheets of large companies. However, the exposure to a potential euro-zone collapse was the major threat facing the British economy.

Business surveys indicate UK recession

For the UK, the contraction in credit growth posed a major obstacle to recovery. While credit availability had improved a little, it was still insufficient to meet the latent demand from small companies. Defaults were rising and spreads remained too tight. Survey evidence suggested that the UK was currently in recession. The Lloyds Business Barometer indicated that the probability of a renewed recession was well above 50%.

Inflation to fall back to target in 2013

Secured borrowing by households had remained flat and unsecured borrowing had picked up only marginally. Total personal borrowing had peaked but high debt levels were holding back the recovery as household sector de-leveraging continued. Net repayments dominated the actions of the corporate sector, with credit growth having remained negative since mid-2009. The company sector financial surplus had continued to rise while investment had declined. Overall, the weakness in broad money growth signalled interest rates would remain low for the foreseeable future. QE had boosted nominal income growth but had demonstrated little ability to stimulate real GDP. However, underlying inflation pressure was likely to be subdued although the inflation target was not likely to be met until 2013.

More protracted downturn than 1930s

The current downturn may not be as deep as the 1930s but it appeared to be more protracted. The forecast for GDP had greater downside risk.

World Economy

Greek default a certainty

Prospects for the world economy depended on whether the expected Greek default was orderly or disorderly, according to Trevor Williams. The baseline assumption was that there would be a Greek default. A 50% haircut was expected around the turn of the year. If the default was orderly, contagion could be avoided. However, the world would be adversely impacted by a disorderly default. Structural shifts within the euro-zone had opened up wide gaps in competitiveness between Germany and many of the other members, so any new currencies would face significant depreciation risk. A euro-zone break-up would impact on the UK through a liquidity squeeze, a tightening of the credit market, a contraction in domestic spending and an appreciation of sterling.

Global credit conditions tightening

Globally, credit conditions were tightening and capital markets were under pressure with widening emerging market bond spreads. A global recovery had been underway at different speeds for the emerging markets and the developed markets but with signs that growth was faltering in 2012. The quicker the eurozone crisis was resolved the better for the world economy.

Discussion

Introduction to discussion

The Chairman thanked Trevor Williams for his presentation before asking both Roger Bootle and Patrick Minford to make their respective comments forthwith, since he knew that both had to leave by 6pm and time was pressing. As there were ten members present, the Chairman also ruled that the last person to physically join the meeting (Patrick Minford) would have his views recorded but his vote discounted. Roger Bootle's comment and vote appears with the other votes below while Patrick Minford's comments follow immediately.

Comment by Parick Minford

Patrick Minford started by stating that monetary policy was in suspense while the euro crisis continued and that voting for a policy was a pointless exercise. That meant his immediate rate recommendation could only have been for a hold where the 9th February decision was concerned. Unfortunately, the euro crisis might continue for some time and QE was not having any effect other than filling the government's coffers by financing gilt sales. Meanwhile, regulatory noises of a super-Basle nature had scared the banks into not lending. This was similar to a situation of financial repression which was affecting small companies particularly badly. Patrick Minford said that it was appropriate to be tough on the commercial banks in a boom but not in a slump. He called for the reversal of the current drive towards excessive bank regulation from the Financial Services Authority and the Vickers Report. Patrick Minford then left the gathering.

Examples provided by earlier break ups of currency unions

The Chairman then opened up the meeting for general discussion. He proposed that, rather than concentrate on the purely domestic situation, the meeting should apply its monetary expertise to discussing the situation in Continental Europe, since the uncertainties in the euro-zone dominated all other factors and he strongly suspected that everybody present would be voting for a Bank Rate 'hold' in any case. He suggested that they should begin with a discussion about the technical feasibility of the break-up of a currency union, particularly as Akos Valentinyi, as a Hungarian, knew a lot more than most people about the collapse of the currency union between Hungary and Austria after World War 1 and Ukraine and Russia after the collapse of the Soviet Union. Akos Valentinyi commented that the integration of financial markets made it difficult to compare the break-up of the euro with the historical precedent of over-stamping a former imperial currency to create a new national one. Peter Warburton added that the web of interconnectedness went deeper than people imagined, particularly through the leverage created by derivatives contracts.

Greek banks effectively bankrupt

Andrew Lilico said that the British banks had been instructed to make contingency plans in case of a euro-area break-up. Trevor Williams said that

Greek banks were effectively bankrupt with the haemorrhage of deposits from Greece. He said that the draw-down of euro deposits in Greece matched the rise in euro deposits in Germany. Andrew Lilico said that he was concerned with the cascade effect of a Greek exit on the UK money supply. David B Smith said that, under such extreme circumstances, the government should stabilise the stock of bank deposits by allowing the budget deficit to be directly monetised until the crisis was over. The UK budget deficit was so large that direct monetisation would be a powerful weapon under these specific circumstances. Jamie Dannhauser said that the Bank of England could switch from being a liquidity provider to being a funder - like the ECB - by buying bonds from the commercial banks.

Banks could suffer far larger capital losses lending to governments than they would lending to companies and households

The discussion went on to include the implications for bank balance sheets of rating downgrades of government bonds. David B Smith said that financial regulators almost universally demanded that banks hold government bonds on alleged prudential grounds. However, there was now a greater probability of major losses on sovereign debt than there was on lending to households and businesses. This meant that such officially imposed balance sheet constraints served no socially useful purpose and mainly served to allow fiscally profligate governments to crowd out potential private-sector borrowers without having to pay the normal interest rate penalty. David B Smith added that the banking sector (and pension funds) would suffer large capital losses if real interest rates simply returned to more normal levels, or inflation premiums rose, causing nominal bond yields to rise and capital values to fall. However, such losses would happen far more dramatically if governments substantially defaulted by haircutting their debt obligations.

GDP distorted by excessive weight of financial services

Jamie Dannhauser added that the difficulty of measuring financial services and the possible overweighting of bank services in the official measure of GDP in the base year of 2008 may have been giving a false picture of where the economy currently was situated. Trevor Williams said that the political climate had created perverse policy reactions that lead to credit tightening when the crying economic need was for a loosening. He said that regulators had to accept that the current situation was partly of their own making through the creation of perverse incentives. Further tightening of the regulatory framework at this stage would make things worse not better.

Call for votes

David B Smith concluded the discussion by suggesting that the uncertainties discussed in the meeting were such that the committee were in the position of a panel of doctors confronted with a patient with a life-threatening but undiagnosable condition. His concern was not so much that the patient would not recover if left well alone, but that ill-advised medical interventions carried out by quack doctors would definitely prove fatal. The sight of politicians and regulators crowding round the British economy with their metaphorical leaches, bleeding cups, and trepanning drills did not inspire confidence, to put it mildly. The Chairman then called on the committee to cast their votes and make their comments on monetary policy. Kent Matthews suggested that they should expand on their views on unconventional monetary policy since no one was calling for a rise in interest rates.

Comment by Roger Bootle

(Capital Economics)
Vote: Hold Bank Rate.

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

Global economy facing an existential crisis

Before he left the meeting, Roger Bootle had stated that he largely agreed with the assessment of Trevor Williams. The global economy was approaching an existential crisis. Greece and possibly Portugal would have to exit the euro. The worst of all outcomes for the world economy was for the euro crisis to drag on. A quick break-up would create immense damage in the short run but the recovery

would be faster and, correspondingly, the better option for the world economy. The potential for a banking crisis that was several times worse than the Lehman one could not be excluded. One ray of sunshine was that inflation would fall below 2% by the end of this year. Those in work would benefit from this. The housing sector could still create problems and a weak economy would continue for two or more years. Since inflation expectations were down, QE could be used more effectively. He therefore voted to maintain the rate of interest and to increase QE

Comment by Jamie Dannhauser

(Lombard Street Research) Vote: Hold Bank Rate.

Bias: Aggressive QE as the euro-zone situation worsens.

QE remains correct policy response

Jamie Dannhauser said that QE had been the correct policy response at the beginning of the crisis and that it remained the correct response now. QE had to be used to offset the effects of tighter conditions in the bank funding markets. Greece was likely to exit the euro-zone within twelve months and could well be followed by Portugal, in his opinion. The responsibility of the British government was to insulate the UK banks from the seemingly inevitable break up. Unless conditions in financial markets improved markedly, additional asset purchases could be needed soon. If the euro area situation worsened, the Bank of England, possibly in co-ordination with HM Treasury, should expand its QE programme dramatically, going beyond gilts to bank debt (including covered bonds and ABS) and potentially even riskier assets. In the event of a disorderly Greek exit from monetary union, preventing a rapid appreciation of sterling would also be important.

Comment by Anthony Evans

(ESCP Europe) Vote: Hold Bank Rate.

Bias: Use QE to stabilise money supply to target nominal GDP.

Policy needs to be reexamined in terms of monetary regimes Anthony Evans said that the problem facing the British monetary authorities was the necessity to make policy decisions based on predictions of what was going to happen to the euro-zone. Policy should not be based on pre-empting disaster, although the Bank of England should be on standby to respond to clear signals of financial distress. He said that he was hesitant to engage in further QE especially when inflation was above target and the money supply was rising. Indeed, he did not think that QE was compatible with the Bank of England's attempt to keep popular inflation expectations at 2%, and that forecasts of CPI returning to target by the end of 2012 constrained its impact. The fact that inflation targets had been more honoured in their breaching than their observance in recent quarters suggested a need to re-examine the whole monetary regime. The policy focus should be to buttress the broad money supply to prevent nominal GDP from falling.

Comment by Andrew Lilico

(Europe Economics)

Vote: Hold Bank Rate; hold QE.

Bias: To raise rates.

Monetary policy is undefined

Andrew Lilico said that he was mystified as to the purpose of monetary policy since there appeared to be no robust inflation target to speak off. The policy discussion was about what to do in the case of a euro-zone collapse. Greek default could occur in the next two months, in which case QE should not be viewed as last resort lending. The Bank of England should not stop banks from going bust. It was likely that monetary policy had gone as far as it could. We may be close to the point where the interest rate had to revert to a Wicksellian

norm – i.e. a real rate of something over 2%. The rate of interest could not stay at the current level forever. The interest rate could remain where it was in the short term. However, a rise was appropriate if the crisis remained unresolved.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Hold Bank Rate.

Bias: To raise; QE to be used only if euro crisis signals danger of UK recession.

Contraction in GDP – permanent or temporary?

Kent Matthews said that the problem for monetary policy was the need to know whether the recent contraction in output was permanent or temporary. The credit crunch that followed the banking crisis had led to considerable capacity destruction in the Bernanke-Gertler sense. However, a permanent contraction in output meant that GDP would not grow back to a 'potential' level defined by some pre-crisis trend but rather grow at the historic trend rate from the low level reached in 2008 and 2009. Maintaining interest rates at their current low level was playing fast and loose with longer term inflation expectations. Admittedly, the Bank of England's prediction that inflation would fall in 2012 looked plausible. However, there remained room for doubt as to whether inflation would reach the target by the year end. Part of the uncertainty was to do with where interest rates will be in the second half of this year. We would have a better idea of whether the economy was close to capacity, or if the Bank was correct in its assessment that there was sufficient capacity in the system to continue to exert downward pressure on inflation, towards the year end. If there was little spare capacity, monetary policy was not just ineffective, it was inappropriate. Currently, we did not know where the economy was.

QE prevented downturn becoming disaster

QE was good at stopping a downturn in the economy from turning into a disaster, in the opinion of Kent Matthews. However, there was little evidence that QE worked to reverse the direction into an upturn. Therefore QE should be used sparingly and held in reserve. He was also not as sanguine about the likelihood of a quick resolution of the euro crisis. The crisis could carry on for another year or longer. In which case, interest rates would need to signal a movement towards a level where real interest rates were positive. There was always the possibility that a Greek exit became a reality in the next few months. In which case, QE could be deployed to counter the liquidity squeeze and the ensuing asset price deflation. In the mean time, we had to wait and see.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Hold Bank Rate.

Bias: To hold Bank Rate, until the euro-zone situation clarifies.

UK has suffered the mother of all supply withdrawals

David B Smith said that the decade of extreme tax-and-spend policies in the UK between 2000 and 2010 had generated the mother of all supply withdrawals and that the Coalition were in a state of psychological denial about the scale of the structural fiscal problem that they had inherited. As a result, there was a danger that policy could over-stimulate home demand relative to the supply base. leading to chronic inflation and a worsening trade gap. If European monetary union genuinely could not be saved, a rapid break-up was the least bad outcome, regardless of how much political 'loss of face' this caused. This was unambiguously preferable to a crisis that dragged on for several years, leading to chronic economic uncertainty and rising social and political tensions across the Continent. The European Central Bank had argued that a major cause of the euro crisis was the inconsistency between the relative fiscal rigour that had been maintained in Germany since monetary union in 2000 and the far more profligate policies that had been adopted elsewhere. He broadly agreed with this view and suspected that Greece, Cyprus and Portugal would all have to guit the eurozone during the course of 2012. However, he was more sanguine about Spain

and Ireland which could regain favourable supply-side flexibility if they returned to their earlier more disciplined fiscal stances.

Euro-zone's problems have distracted market attention from weak UK policy stance The problems within the euro-zone had distracted market attention from the issues of the long-term viability of UK sovereign debt, in David B Smith's view. The Coalition had inherited a dreadful fiscal mess but it had also chickened out of taking the measures needed to stabilise the fiscal situation in the long run and to improve the supply-side of the British economy. He was also profoundly concerned that the domestic financial regulators had got the bit between their teeth and were attempting to gold plate the already excessively tight regulations stemming from Basle III and the European Union. The solution to the 'too big to fail problem' was to break up the large banking groups using the normal tools of anti-monopoly policy, not to strangle money and credit creation through excessive regulation. Public choice theory suggested that bureaucracies always tended to over-regulate financial institutions - regardless of the social costs and benefits involved – because this minimised the apparent risk of embarrassing institutional failures, even if officials were half-asleep on the job as they had been before the crisis, and also maximised the extent of the bureaucratic empires concerned. Monetary policy in the immediate future should be to hold Bank Rate and to stop M4^{ex} from falling, using the full range of monetary tools including QE when appropriate. However, he thought that QE was best employed when the Central Bank had to act as a lender of last resort and was not convinced that it was an appropriate implement for demand management purposes on a day to day basis. One reason was that it probably was not as effective as the Bank of England appeared to believe. Another was the political moral hazard it engendered because it allowed fiscal profligacy to become a free good where the political and bureaucratic interests were concerned.

Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Hold Bank Rate.

Bias: To tighten, unless inflation eases sharply.

Inflation should be priority

Akos Valentinyi said that there remained significant inflation risks. The Bank of England had consistently under predicted inflation in the past three years. As a result its credibility was weak. It was difficult to see how the euro-zone crisis would play out. It could turn out to be worse than a sovereign debt crisis. The imbalances in the euro-zone went well beyond fiscal policy. There were deep structural problems. The exit of Greece and Portugal from the Euro was possible. However, and until the uncertainty in the euro-zone was resolved, the Bank of England's priority should be the inflation target. The inflation figures were more transparent and better understood that nominal income, given the delays and uncertainty of the Office for National Statistics (ONS) figures. He said that QE should be put on hold for the moment.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Hold Bank Rate; no extension of QE; reinstate the Special Liquidity Scheme. Bias: To raise Bank Rate before the end of 2012.

UK capable of producing 1% to 2% growth

Peter Warburton said that, on a global basis, the pace of private sector credit growth had not slowed, despite the numerous surveys showing a tightening of credit conditions. Overall, there had been no deceleration of global credit aggregates and hence no strong expectation that the global economy would slide into anything worse than an inventory downturn. This was not shaping up as a repeat of the experience of 2008 and 2009. The UK was perfectly capable of generating 1% to 2% GDP growth in 2012, even after accepting that the Euro crisis could knock growth back by an indeterminate amount. The Bank of England had effectively killed off the wholesale money markets and it should

support collateralised alternative to the moribund inter-bank market. It was wrong to think that UK banks could be weaned off their dependence on wholesale markets, including securitisations, completely. There was a need to widen the range of eligible collateral to provide greater flexibility for the banking sector in meeting its funding requirements.

US model should not be copied

QE had induced some positive effects but these were diminishing, in Peter Warburton's opinion. The case for additional QE was unconvincing. The road of pre-commitment to emergency low levels of policy interest rates was ill-advised; the US Federal Reserve's recent willingness to do so should not be copied in the UK. Rather, by revitalising the wholesale markets, the Bank of England should be looking to re-engage Bank Rate with the structure of market interest rates later in the year with at least one token Bank Rate increase.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)

Vote: Hold.

Bias: To loosen via QE.

QE to to be extended by £75 billion.

Trevor Williams said that the rate of interest had to remain on hold until the situation had normalised. European Central Bank type lending could be followed by the Bank of England but QE was probably more workable in the UK context. QE did have an effect on ten-year gilt rates and it also minimised defaults. He said that he was sympathetic to those banks that had responded to regulation by increasing reserves with the central bank, because they were fearful of being caught short of capital. However, central banks had sent the wrong message to the commercial banks and households creating a moral hazard problem of their own making. QE could be deployed effectively in the context of the euro crisis. He said that QE should be extended by £75bn from its current position and even increased up to a total stock of £500bn in case of serious fallout from the euro crisis.

Policy response

- 1. There was unanimity that Bank rate should remain on hold in February and probably until the outcome of the euro crisis was clarified.
- There was general acceptance that the euro crisis would come to a head in the first half of 2012 with the likely exit of Greece from the euro-zone.
 However, two members of the committee felt that the crisis could continue to be unresolved for longer.
- Several SMPC members indicated a bias to raise Bank Rate in the future, while accepting that this was not appropriate at the moment when QE was a superior monetary tool. However, there was a bias to get back to a more 'normal' rate of interest as soon as this became practical.

Date of next meeting

Tuesday, 17th April 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.

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