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Shadow Monetary Policy Committee
E-Mail Poll: January 2009

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Keep Bank Rate at 2% in January but unveil 'Unconventional' Measures, Says IEA's Shadow Monetary Policy Committee

In its latest E-mail poll (carried out in conjunction with the *Sunday Times*) the Shadow Monetary Policy Committee (SMPC) voted that UK Bank Rate should be kept unchanged on 8th January. In particular, six members of the Institute of Economic Affair's shadow committee voted to leave Bank Rate unaltered at 2%, two SMPC members favoured a cut to 1%, and one argued for a ½ percentage point reduction. There was a general view that the benefits from further cuts in Bank Rate were subject to rapidly diminishing returns and that there was a need for additional monetary instruments. One suggestion was that the remit of the Debt Management Office (DMO) should be altered to allow the government to borrow directly from the banking sector, in order to boost bank liquidity and the broad money supply. Several SMPC members criticised the government's incoherent and damaging approach to the banking system. In particular, senior politicians' populist demands for lower borrowing costs were logically incompatible with the need to re-capitalise the sector. The SMPC poll was closed on Tuesday 30th December.

The SMPC itself is a group of economists who assemble once a quarter at the Institute of Economic Affairs (IEA) in Westminster. The inaugural SMPC meeting was held in July 1997. That it is the first such body in the UK, and meets regularly to discuss the deeper issues involved, distinguishes the IEA's SMPC from the similar exercises now carried out by several publications. The material that follows appears with the permission of the original authors and has not been amended by Lombard Street Research. The first SMPC gathering of the New Year will be on Tuesday 13th January 2009. The detailed minutes of that meeting will be published on Sunday 1st February. Subsequent E-mail polls are scheduled for release on Sunday 1st March and Sunday 5th April 2009.

For Further Information Please Contact:

David B Smith + (0) 1923 897885 **xxxbeaconxxx@btinternet.com**

Philip Booth + (0) 20 7799 8912 **pbooth@iea.org.uk**

Lombard Street Research
www.lombardstreetresearch.com

Comment by Tim Congdon
(Founder, Lombard Street Research)
Vote: Hold
Bias: Neutral

Monetary policy involves more than rate setting

The events of 2008 have shown that monetary policy-making consists of much more than the setting of interest rates by a committee of the great and the good. For many years British banks did not give a thought to cash and liquidity as constraints on their operations, while capital grew steadily out of profit retentions. But in 2008 liquidity and solvency have become major issues for British banks' managements, and the level of the nominal short-term interest rate associated with moderate growth of credit and money (and so with wider macro- equilibrium) has collapsed.

Should rates go to zero?

Do interest rates need to go to zero to prevent deflation? In my view British banks are not undercapitalised, and 2009 will see some writing-back of losses taken on mortgage-backed securities as well as increased loan losses on mainstream UK banking business. The banks could well be over-capitalised by 2011 or 2012. The result, if interest rates are cut too much now, will be yet another silly cycle.

Government debt management can end liquidity squeeze

My strong preference now is for the UK authorities to ensure that the government borrows from the banks and increases the amount of money (i.e. bank deposits) that way. I believe that, handled properly, debt management operations of this kind could add 5% to deposits in the first quarter of 2009, ending the liquidity squeeze and the worst of the recession.

Hold

My position on interest rates is "no change", with a future bias towards "no change".

Comment by John Greenwood
(Invesco Asset Management)
Vote: Cut by ½%
Bias: To ease

The monetary challenge

The challenge facing British monetary policy-makers today is to get back to the pre-2005 conditions when both bank and non-bank financial institution balance sheets (in aggregate) were growing at moderate, single-digit rates.

Divergent trends within the financial system

Today there are highly divergent trends within the financial system. On the one hand the balance sheets of non-bank financial institutions or shadow banks are either shrinking or not growing at all as the financial system attempts to reduce leverage. On the other hand the M4 components and counterparts of banks' balance sheets are temporarily growing very rapidly as banks accommodate the urgent credit demands of other financial corporations (OFCs) which are no longer able to borrow from the capital markets or other non-bank sources. Both of these trends are short-term phenomena reflecting the abrupt adjustment of the economy to slower overall credit growth. They are not long-term equilibrium positions.

Re-intermediation explains rapid monetary growth

This kind of re-intermediation of credit back to the banks is the explanation for the surge in M4 broad money growth in November to 16.3% (year-on-year). Based on the October data most of this surge in bank balance sheets is due to loans to OFCs (+42.8%) and balances held by OFCs (+44.1%). Meanwhile, money held by households and non-financial corporations (retail M4) has slowed abruptly to 5.2% in October, and non-financial corporate and household borrowing from the banks has slowed to 6.3%. In short, it seems possible that non-financial borrowers are being crowded out by financial sector borrowers. These stresses may well be exacerbated as the government's borrowings increase in line with its budget deficit. However, this view is too simplistic.

Banks are severely capital constrained

The basic problem is that on the supply side, banks and non-bank financial institutions are severely capital-constrained, and market concerns about capital erosion will escalate as the recession deepens, keeping inter-bank rates at a premium to Bank Rate. To ensure that banks are still able to generate new credit and are willing to lend in the interbank markets at minimal premia to Bank Rate, they need to be very strongly capitalised. The quickest and cleanest way to achieve this is to remove all bad or toxic loans from banks' balance sheets, placing them in a government-owned, special purpose asset management company for gradual disposal. In exchange, the banks would receive government bonds at a price reflecting the valuation of their toxic assets, and be obliged to accept a matching infusion of capital from the government. The remaining elements of each bank will then be largely problem-free, more able to raise capital, and more willing to supply credit to private sector or public sector borrowers as required. Over time the government would sell down its bank share-holdings.

Excess indebtedness of households

On the demand side, non-bank financial companies and households (and to a lesser extent non-financial companies) have all built up over-indebted balance sheets, and therefore do not wish to borrow while asset prices are falling. The solution for these entities lies in allowing them the maximum opportunity to repair their balance sheets (e.g. by selling assets to pay down debt, or raising new capital), while at the same time attempting to ensure that the cost of funds is minimised. Base Rate should therefore be reduced further.

Overall credit growth is more important than that of banks alone

This balance sheet-based analysis makes it clear first that demand for credit from the non-financial sector is likely to be very weak over the next year or two as households, industrial and commercial companies, and non-bank financial institutions reduce their gearing further. It follows that the authorities should curtail their demands for banks to increase lending. Second, it also demonstrates that in future the authorities need to pay attention to overall credit growth, not simply the growth of bank credit or money created by the banks and building societies together (M4). In the meantime, the best the authorities can do is to try to ensure that money balances held by households and industrial and commercial companies continue to grow at a positive, single-digit pace. One way to help attain this result would be to ensure that banks expand their balance sheets by buying government debt, or lend directly to the government.

Cut by ½%

Both the supply side and demand side problems in the credit markets would be alleviated by a further reduction in Bank Rate, but this is not a panacea. More assistance is needed in sorting out the balance sheet problems of both lenders and borrowers across the economy.

Comment by Andrew Lilico
(Europe Economics)
Vote: Hold
Bias: To cut

Shrinking economy will eventually require lower rates...

Eventually, Bank Rate will need to be cut to ½% or below. In the coming year the economy will probably shrink by 2.5%-3%, with perhaps a slight temporary recovery in the final quarter of 2009 or the first quarter of 2010 as the large interest rate cuts of recent months have their effect. Unemployment is likely to exceed three million, and the combination of unemployment and deflation will drive mass bankruptcies. The government's complete lack of realism over its growth and tax receipt forecasts has badly undermined confidence in the pound. It is vital that more plausible growth forecasts and a more achievable rectification path for the budget deficit be produced soon. House prices will fall rapidly through the next year and into 2010, probably by more than 35% peak-to-trough - placing many people in negative equity and undermining labour mobility. The situation is the worst for many decades.

...but not yet and other monetary measures should be tried

For the moment, however, I believe that enough work has been done in terms of cutting interest rates, and the focus should switch to alternative ways to boost the money supply. Direct money printing to fund the deficit should be being planned for as part of the 2009/10 Budget. Some borrowings from commercial banks may also have a role to play. Once the nature and extent of these monetary measures is clearer, we will be better placed to judge the next moves on interest rates. For the moment, I would hold back, temporarily, to await developments.

Comment by Ruth Lea
(Arbuthnot Banking Group)
Vote: Cut by 1%
Bias: To hold

Worsening global economic data

The economic data continue to worsen across the globe. What makes this recession so insidious is the combination of global recession (thus inevitably muting any fillip the British economy should get from the weaker pound) and the dysfunctional financial markets. In the UK the latest figures confirm a consistently deteriorating situation. The third quarter GDP fall was marginally extended (from 0.5% to 0.6%) but, of more relevance, the expectations are currently for a fall of around 1% in the fourth quarter, given NIESR's estimate of a decrease of 1% in the three months to November. The housing market continues to weaken. According to the British Bankers' Association (BBA) mortgage lending by the major banks continues to fall sharply, with approvals for house purchases in November 60% down year-on-year. Unemployment is now rising very sharply.

Balance sheets

Given the deepening recession, banks appear unwilling to lend, as they seek to repair their balance sheets and (logically) adopt a risk-averse stance in the face of rising defaults. Moreover, they are not 'passing on the full cuts' in official rates to their customers, despite exhortations from the Prime Minister, not least of all because the cost of money to them, either through the inter-bank market or from depositors, is higher than Bank Rate. The continued disruption to the wholesale markets and the tighter regulatory requirements by the Financial Services Authority (FSA) add to their inability to deliver the lending munificence that the Government would doubtless like to see. On the other side of the equation, companies and individuals are probably wishing to cut back their indebtedness (the saving ratio rose to 1.8% in the third quarter compared with minus 1.3% in the first quarter of 2008).

Quantitative easing and government loan guarantees

Given these circumstances, further cuts in interest rates can only have a muted effect on lending and other instruments, including quantitative easing and Government loan guarantees, are increasingly taking centre-stage. In addition the FSA could help banks by being more flexible with the way in which capital market assets are valued and relax the rules that enforce 'procyclicality'. But, having said that further cuts will be of limited value, there is still purpose in cutting them. And I vote for a 1% cut in January – but hold thereafter.

Comment by Kent Matthews
(Cardiff Business School, Cardiff University)
Vote: No Change
Bias: Neutral

Scope for further Bank Rate cuts to influence the real economy is approaching exhaustion

It is getting increasingly clear that cuts in Bank Rate have played as far as they could go in monetary easing. The spread of the London Inter-Bank Offerred Rate (LIBOR) over Bank Rate remains stubbornly high but this is not the real issue. Anecdotal evidence suggests that inter-bank credit is not available in many cases and that quoted LIBOR is very much an irrelevance to many but the largest and best rated financial institutions. If this is true it means that the credit crunch has reached the stage of market based credit rationing, with the market defining quantitative restrictions. Therefore making credit cheaper does not necessarily mean making credit more available. Endogenous quantitative restrictions will have to be met with quantitative policy reactions aimed at increasing liquidity. Monetisation of borrowing by the government and even monetisation of existing debt are potential avenues for the Bank of England and HM Treasury to consider. Interest rates have gone as far as they can go and quantitative policy easing has to be considered in the short term.

Comment by Gordon Pepper
(Lombard Street Research and Cass Business School)
Vote: Hold but the DMO should suspend sales of gilt-edged stock
Bias: Towards further quantitative expansion measures

Exhausted bank reserves

At the end of June 2007, just before the current crisis broke, commercial banks' holdings of gilt-edged stock were *minus* £13.6bn. This is a spectacular illustration of the way in which banks had run out of eligible assets for conducting sale and repurchase agreements (REPOs) with the Bank of England under the eligibility rules at the time. They had run out of reserves. From the banking point of view, the background was that banks were very happy at the time to hold zero reserves. The Bank stood willing to supply whatever quantity of reserves banks wanted each day (subject to the price - that is, the rate of interest - of the Bank's own choosing). In other words, the Bank was an openly declared unlimited lender-of-first resort, which satisfied the requirements for reserves of banks as a whole. *Providing the inter-bank market was functioning efficiently*, money would flow from banks flush with reserves to those short of them and an individual bank could be confident that it could obtain finance when it was needed and had no need to hold reserves in advance of need. Indeed, banks made a profit out of holding assets with a higher return.

PSNCR, funding policy, and reserve assets

The other half of the explanation is that there are three sources from which the government can borrow to finance a deficit, namely: (i) banks; (ii) the non-bank private sector; and (iii) non-residents. It follows that borrowing from banks - that is, mainly changes in banks' holdings of treasury bills and gilts - is equal to the public sector net cash requirement (PSNCR) less sales of gilts, etc. to the non-bank private sector and to non-residents. In the mid 1980s, banks' holdings of government debt fell when sales of gilts to non-banks exceeded the PSNCR because the then Chancellor, Nigel Lawson, was following a policy of overfunding to control the money supply. At the time the discount market existed and commercial bills guaranteed by a discount house and 'accepted' by an acceptance house (i.e. guaranteed by two banks) became eligible for discount at the Bank. Such reserve assets could be manufactured at will by banks persuading their customers to issue a bill rather than draw down on a loan facility. Their customers would be happy to do so if issuing a bill were cheaper. In the mid-1980s the Bank purchased a huge quantity of eligible bills to relieve the squeeze caused by over-funding. The Bank's 'bill mountain' of the time thus acted as a safety valve.

Non-resident purchases of gilts have drained banks' reserve assets

The discount market and eligible bills no longer exist. They have been replaced by REPOs. This time round, non-resident purchases of gilts have been greater than the PSNCR. In the twelve months to end June 2007, non-residents bought no less than £42bn gilts compared with a PSNCR of £28bn. In the previous year they bought £31bn gilts. It is no wonder that banks had run out of assets eligible for REPO. The safety valve was borrowed stock. This is why banks' holding of gilts were so massively negative at the end of June 2007. Two questions arise from this analysis. Firstly, why was the Bank so slow to extend the range of assets that qualified for REPO when the crisis broke? Second, did the Bank not understand what had happened?

1) The Story

Central bank intervention

The non-residents who purchased the huge quantities of gilts were either investors who thought that sterling and gilts were attractive or central banks that wanted to earn interest on their holdings of foreign exchange. The latter are likely to account for the bulk of the rise. A story can now be pieced together. The Peoples Bank of China intervened in the foreign exchange markets to stop the yuan from rising and China's foreign exchange reserves rose by a huge amount. To earn interest on the reserves they were held partly on deposit with banks and partly invested in government debt. The former provided the finance for banks in the US and the UK to lend like mad whereas the latter sucked reserves out of their banking systems. When the bubble bursts, as it was bound to eventually, confidence collapsed in the inter-bank market. Banks then went from being happy with no reserves to wanting them, perhaps to the extent of 10% of their liabilities. And the starting position in the UK was one of large-scale borrowed stock. It is no wonder that banks have been reluctant to lend in spite of the injection of capital from the government.

2) Required Action

DMO should suspend gilt sales

When the government makes a payment to someone by cheque the person's deposit with his or her bank increases, at the time the cheque is cleared, as does the bank's balance with the Bank of England. This boosts bank reserves and is exactly what is wanted in the present extraordinary circumstances. For the time being the Debt Management Office (DMO) should suspend sales of gilts and further measures of quantitative easing should be prepared if this proves inadequate.

Comment by David B Smith
(University of Derby and Beacon Economic Forecasting)
Vote: Hold
Bias: Wait and see but enough stimulus has probably been applied for the time being

Dangers of monetary oversteering

There comes a point in every monetary easing cycle when it is appropriate to pause for breath and consider what the ultimate effects of the preceeding rate reductions will be, after allowing for the long and variable lags involved. The reason Keynesian demand-management policies fell out of favour in the 1970s, for example, is that it became obvious that the information and implementation lags were such that discretionary policies were exacerbating the underlying business cycle. Likewise, global monetary policy has arguably been perversely de-stabilising since the bail out of Long-Term Capital Management a decade ago. US policy makers, in particular, have aggressively cut rates at the first imagined sight of bogey men in the financial markets. The result has been that they lost control over credit and broad money and created the financial bubble that should have been popped much earlier. Macro-economic modellers have long known that discretionary monetary policies, that vary the real REPO rate in response to the output gap, can end up de-stabilising the economy under the wrong circumstances. Simple rules – such as setting the REPO rate at inflation plus, say, 2% - often give better results in model simulations when more interventionist policies seem to generate cyclical fluctuations of their own. This is just a standard problem in control theory, of course. The authorities clearly hoped that putting policy onto a forward-looking basis using a formal predictive framework would prevent some of these destabilsing tendencies. Unfortunately, the failure of almost everybody in officialdom, politics, or the private sector to correctly anticipate developments from mid 2007 onwards implies that forward-looking policies are based on such uncertain foundations that they can prove as potentially de-stabilising as the old backward looking kind.

'Recession' reflects supply-side degredation, not just weak demand

Britain has a small open economy and the effects of a given policy stance on domestic developments is heavily conditioned by the wider global background. There are several causes of the present global recession, which is not just the result of the 'credit crunch'. Most commentators have concentrated on demand effects. However, there has probably been an additional element of supply-side degradation in both the US and Britain, where the share of government spending in national output has risen markedly over the past decade. Applying the normal statistical rule of thumb – that a 1% increase in the share of non-productive public spending in GDP reduces the growth of per capita real GDP by 0.15 to 0.2 percentage points – suggests that increased public expenditure will have reduced the sustainable growth rate in the US and the UK by some 1 to 1¼ percentage points since the turn of the century. Reduced aggregate supply would explain the weakness of equity markets, whose level reflects the net present value of the future stream of real corporate earnings, despite low real bond yields, which are themselves partly determined by the sustainable rate of economic growth.

Both oil-price and 'credit-crunch' shocks were behind the recession, but oil-price shock has been reversed

Turning to the more conventional influences on activity, one forecasting problem is that the world economy has suffered not one, but two, adverse shocks in recent years. This makes it difficult to disentangle their relative significance. The first was the rise in the price of a barrel of Brent Crude oil from US$54 in January 2007 to US$134 in July 2008. Model simulations indicate that this would have had a major adverse impact on global activity, even in the absence of a credit crunch. The second adverse factor has been the 'credit crunch' itself. A credit crunch can be regarded as a situation where credit is rationed by availability rather than the rate of interest. The latest 'crunch' occurred at the same time as the oil price shock and may have been partly caused by it. However, the oil price has since fallen to US$40.5 (on 29th December). One could argue, therefore, that the world economy will be rebounding strongly by late 2009, after allowing for the normal lags involved, if the previous oil price shock had been a substantial contributor to the global downturn.

Macroeconomic forecasting models seem to have broken down

Any attempt to analyse the impact of the credit crunch encounters the problem that none of the macroeconomic forecasting models employed by the leading central banks, ministries of finance, or academia incorporate credit rationing effects (the same is true of the *Beacon Economic Forecasting* model). The recession is almost certainly being built into published forecasts by the use of large negative adjustments to the underlying model predictions (it would be interesting to know how much of the change in the Bank of England's *Inflation Report* forecasts between August and November 2008 was the result of such adjustments, for example). Such downwards adjustments may well be realistic. However, they also mean that virtually the entire global model-building community is flying blind. The critical forecasting issues then are: (i) when and whether such downwards adjustments should be removed; and (ii) what happens once the negative adjustments come off. If the models have not broken down entirely – which is clearly conceivable – one could be looking at a strong rebound in late 2009 and 2010, just when the lagged effects of current low interest rates and fiscal relaxation are building up to their peak.

There was a remarkably strong recovery from the Depression of the 1930s

In the November 2008 *Pre-Budget Report,* HM Treasury assumed that there will be a permanent loss of output of 4% of GDP as a result of the global credit crunch but it is really too early to say. From a theoretical perspective, a credit crunch presumably acts like an unanticipated negative monetary shock in a monetary model, or an adverse relative price shock in a real business cycle model. Both approaches suggest that the economy should eventually return to its underlying growth trend and there should be no permanent loss of output beyond that already caused by Gordon Brown's manic interventionism, unless the quack measures now being introduced by politicians make matters worse rather than better. This happened with Roosevelt's New Deal and is likely to happen in the US, Britain and other modern economies. Fortunately, there is evidence from both the 1930s and subsequent recessions that the speed of recovery is greater, the deeper the previous recession. For example, the sequence of growth rates in UK GDP between 1930 and 1938 reads: 1930 minus 0.7%, 1931 minus 5.1%, 1932 plus 0.8%, 1933 +2.9%, 1934 +6.6%, 1935 +3.8%, 1936 +4.5%, 1937 +3.5% and 1938 +1.2%.

Hold rates in January

As far as the 8th January rate decision is concerned, the MPC have now probably done enough for the time being and should hold Bank Rate at the 2% announced on 4th December. One reason for caution is that the trade-weighted sterling index was 24½% down on a year earlier on 29th December. This should provide some succour to Britain's excessively small tradables sector. However, it also represents a potential inflation risk, given that imports account for roughly one third of the basic-price measure of UK GDP. The pound's weakness may explain why annual CPI inflation in the UK only decelerated by 0.4 percentage points between October and November 2008, while US inflation eased by 2.6 percentage points (3.7% to 1.1%), and Euro-zone inflation declined by 1.1 percentage points (3.2% to 2.1%). However, an alternative explanation may be that the UK CPI is compiled relatively early in the month. Fortunately, the falls in the prices of oil and non-oil commodities, and the emergence of a substantial negative output gap in the OECD area as a whole, will limit the upside risks to UK inflation throughout 2009. It is possible that the second half of 2009 will see small – but not economically damaging – negative figures for the year-on-year CPI inflation rate, before there is a rebound back to positive inflation in 2010.

Present official interventions in the UK banking sector are incoherent and damaging

More generally, the most pressing monetary policy need is not to cut Bank Rate further but to ensure that the politicians, the Bank of England, HM Treasury and the FSA get their combined act together with respect to their interventions in the UK banking sector. Present official initiatives are a damaging and logically inconsistent mess with the different official players frequently going off at tangents to – and occasionally briefing against - each other. The Prime Minister's demand for low borrowing costs is palpably inconsistent with the recognised need to re-capitalise the banking system. It is not difficult to understand why one UK clearing bank allegedly considered Libya's Colonel Gadaffi a better bet than Gordon Brown as a potential re-capitalisation partner.

Comment by Peter J Warburton
(Economic Perspectives Ltd)
Vote: Hold
Bias: Neutral

The government is still fumbling for an effective response to the credit crisis

It is deeply regrettable that, sixteen months after the eruption of the credit crisis, the government is still fumbling for an effective response. Plainly, its advisors did not expect the crisis to have a material impact on the macro-economy, did not forecast a recession, nor did they prepare the government's finances for such an eventuality. Banks must be allowed to rebuild their historic intermediary functions on a profitable basis as a stepping stone to systemic recovery. The incoherence in the response of the UK authorities to the credit and financial crisis emanates from a neglect of the study of the evolving transmissions between the financial and real (output and employment) sectors of the economy. The adoption of inflation targeting in 1992 fostered a black-box approach to monetary policy which has proved costly in current circumstances. Interest in the behaviour of credit and monetary aggregates waned accordingly and important skill-sets have been lost to the Bank of England and the financial sector in general. Hence the policy responses to the crisis have been piecemeal and often ill-considered. They do not fit together as a coherent strategy.

Six suggestions for improvement

Six desirable outcomes for economic policy are outlined below, with some suggestions as to how they might be achieved.

1) Normalisation of the Inter-bank Market

LIBOR spread still too high

On this score, there is no magic solution but rather a progressive determination to provide as much central bank liquidity as is necessary through as many different channels as is helpful. Three-month sterling LIBOR is quoted at 2.87% versus a 2% Bank Rate while three-month Euro LIBOR trades at 49 basis points over the REPO rate. The UK appears to be lagging in the normalisation stakes.

2) Suspension of Inappropriate Capital Adequacy Rules

Basel 2 rules are de-stabilising and should be suspended

Basel 2 capital adequacy rules, introduced at the start of 2008, require banks to recompute the amount of their risk-weighted assets each quarter. When property asset values are falling at an annual pace of 10% or more, this causes more of a bank's mortgage assets to migrate into higher loan-to-value categories. This insists that banks post more capital against their loans at a time when their profitability is low and they need to make increasing loan loss provisions. Until the rules can be redesigned to work counter-cyclically, my suggestion is that banks' capital requirements revert to and are frozen at their end-June 2007 levels.

3) Restoration of Profitability to the Banks

Banks need to re-build profitability

If the objective is to enable the banks to write down their impaired assets to prevailing market valuations, where these exist, then the restoration of bank profitability is an imperative. The higher the profits, the faster the write-downs can be achieved and the sooner the self-healing properties of markets can take over. Currently, the banks are under official pressure to pass on Bank Rate reductions to the private sector. However, their cost of funding in the inter-bank market has not fallen as rapidly or as far as Bank Rate. And banks are reticent to pay a zero interest rate on bank deposits, which would be another way to make a significant profit in a low bank rate environment. If the purpose of ultra-low Bank Rate was to invite the banks to take a turn on the official yield curve, this isn't working either. At 2.52%, five-year gilts yield less than three-month LIBOR (2.87%). The situation is aggravated by the more attractive saving rates offered by Northern Rock and National Savings and Investments products. The authorities give support to the banks with one hand and seek to punish them with the other. This ambiguity needs to be removed to allow banks to rebuild their profitability.

4) Re-direction of Banks' Lending Capacity towards Non-financial Companies and Households

Pipeline of maturing issues

Following the remarks in the earlier sections, the key to this re-direction lies in the "dialysis" of banks' maturing obligations. While it is helpful for banks to be able to issue new asset-backed securities into the Special Liquidity Scheme (SLS), a much bigger problem is the pipeline of maturing issues than cannot be refinanced in current market conditions. While the flow of new credit to the private sector is hindered as much as by demand as supply, there are reasonable grounds to suppose that a partial normalisation in credit volumes would occur if banks were less concerned to protect their financial subsidiaries and connected activities.

5) Reversal of the Ludicrous "Over-funding" of the Budget Deficit

DMO remit has perverse consequences

In the circumstances of the credit crisis, the 1998 remit of the DMO makes no sense. Since the summer, the DMO has been issuing additional gilts opportunistically into a strong market, that is, a flight-to-safety market. As a result of incremental gilt issuance and the popularity of

National Savings products, the DMO has garnered over £20bn more than would be required to fund public sector borrowing. In other words, the DMO has been covertly "overfunding" the public sector's net cash requirement. Essentially, it has been draining bank deposits from the private sector. This policy will reverse naturally as the PSNCR explodes, but it is important that DMO's remit is amended to permit significant "under-funding" in the coming years.

6) Discouragement of Flows into National Savings and Other Tax-free Savings Vehicles

Government abuse

The government must not abuse its privileged position to outbid the banks for deposits as has begun to happen over the summer. The stock of bank deposits held by private non-financial corporations and households dipped in October as businesses suffered negative cash-flow in aggregate and households switched from bank accounts to National Savings and other forms of saving. A loss of deposits must surely curtail banks' willingness and capacity to lend. A suggested way to bolster bank deposits is either for the government to borrow directly from the banks, or to ensure that banks buy large amounts of Treasury bills and gilts.

Other measures are more important than rate cuts

I believe that the restoration of bank profitability is served better by working to normalise the interbank rate curve and to reverse the outflows from private sector bank deposits than by a further reduction in Bank Rate. Hence my vote is to leave Bank Rate at 2%.

Comment by Trevor Williams
(*Lloyds TSB Corporate Markets)*
Vote: Cut by 1%
Bias: To ease

Big risks are being taken, but past excesses mean there are no easy options

My vote is for a cut of 1% in Bank Rate in January 2009, with a bias to ease further in later months. Such a cut would mean that the MPC is in a position where monetary policy is loose enough to buy it some time to decide whether the situation effectively warrants zero interest rates and what kind of quantitative easing it should pursue. That the MPC must use its tools to pursue policies that expand money supply at a time that liquidity is scarce, is almost a certainty. The economic situation is deteriorating very quickly, and it is now certain that without even more dramatic action it will get a lot worse. Britain's GDP is likely to have dropped by over 1% in the final quarter of last year. Further rate cuts will not prevent a fall in UK GDP of around 2% or more in 2009. However, central action to get money to firms that require it through firstly, purchasing commercial bills and, second, cutting rates to about zero will mitigate the downturn. This means big risks are being taken. Unfortunately, the excessively lax policy stance of the past decade means that an even looser one is now required to prevent a worse economic outcome.

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 e-mail poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

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 current members of the Committee include: Patrick Minford (Cardiff Business School, Cardiff University), Tim Congdon (Founder, Lombard Street Research), Gordon Pepper (Lombard Street Research and Cass Business School), Anne Sibert (Birkbeck College), Peter Warburton (Economic Perspectives Ltd), Roger Bootle (Deloitte and Capital Economics Ltd), John Greenwood (Invesco Asset Management), Peter Spencer (University of York), Andrew Lilico (Europe Economics), Ruth Lea (Arbuthnot Banking Group), 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 nine votes are cast.

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 7382 5911 (direct)
+44 (0) 20 7382 5900 (switch board)
pippa@lombardstreetresearch.com