





## Minutes of the Meeting of 19<sup>th</sup> January 2010 (5pm)

**Attendance:** Philip Booth (IEA Observer), Ruth Lea, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David Brian Smith (Chair), David Henry Smith (*Sunday Times* observer), Peter Warburton, Trevor Williams, External observers Hiroshi Oka (Minister for Economic Affairs, Embassy of Japan), Hajime Yoshimoto (Senior Economic Analyst, Embassy of Japan), party from North London Collegiate School.

**Apologies:** Roger Bootle, Tim Congdon, John Greenwood, Gordon Pepper, Peter Spencer, Mike Wickens.

### Chairman's comments

David B Smith welcomed the external observers and explained to the school visitors the way the SMPC worked. He then called upon on Andrew Lilico to provide his analysis of the global and domestic monetary situation.

### The Monetary Situation

#### *The International Situation – Signs of fragile recovery*

Andrew Lilico referred to his previously prepared slides on the 'Background to SMPC Decision' (*Editorial note:* the slides concerned can be obtained from [Andrew.Lilico@policyexchange.org.uk](mailto:Andrew.Lilico@policyexchange.org.uk)). He began by examining various world economic indicators. These included international stock market prices, the OECD's composite leading indices and the NIESR indicator of recession in advanced countries – all of which were showing signs of recovery in recent quarters and indications of positive growth in the final quarter of last year. However, fragility remained with global house prices still looking strongly overvalued in some economies, widening spreads in government bond yields over German Bund yields and low broad money growth.

#### *The UK Economy – Halfway through deleveraging process*

The contraction in UK national output has been about 6%, according to Andrew Lilico. The December 2009 *Pre-Budget Report* figures and Bank of England projections suggested growth of around 4% in 2011, but the average of independent forecasters saw only a moderate pick up in 2010 and 2% growth in 2011. As with the world economy, the various British indicators – including the Purchasing Managers Supply Index, new car registrations, business climate surveys and consumer confidence indicators - suggested an emergent recovery. The poor December 2009 inflation figures reflected the unwinding of VAT and oil price effects twelve months earlier and should not have been unexpected, even if they were worse than the City had predicted. The Bank of England expected a drop off by the end of this year. One reason was that underlying monetary pressure remained weak, with a continued low growth in the M4X definition of broad money. The cumulative level of Quantitative Easing (QE) was now close to the currently intended maximum. Gilt yields showed no discernible change.

Turning to the section of his presentation that dealt with 'Headwinds and Threats', Andrew Lilico examined the developments in non-financial corporations indebtedness, the savings ratio, and household liabilities as a proportion of nominal disposable income. Using a simple macroeconomic model, he examined the question 'how much deleveraging is there to go?' Some heuristic calculations suggest that the economy was half-way through the deleveraging process. Commercial banks had to raise capital faster than losses materialised. Unemployment may not have peaked and only remained low due to pay freezes or cuts in wages. The figures for government expenditure as a share of GDP, falling public sector receipts, widening spreads on bond yields and rising budget deficit all demonstrated the need for robust fiscal consolidation.

Indicators point to fragile recovery

Recent UK output, inflation and monetary indicators

Uncertain recovery but headwinds and threats remain

## High risk of 'double-dip' recession

### Judgement

Andrew Lilico summed up his presentation. He said that the growth outlook was uncertain and the risk of a double-dip recession was high. He said that he expected a large rise in unemployment followed by more defaults. House prices had further to fall. The main domestic risk was deflation, through wage cuts and defaults leading to more banking sector problems. Fiscal consolidation was both necessary and inevitable and should be combined with monetary easing. He said that QE should be paused so that something could be held back for later.

## Monetary base

Patrick Minford asked why QE was not showing up in the M0 monetary base. Andrew Lilico said that the Bank did not publish data on M0 anymore but it can be constructed by adding cash reserves and bankers deposits at the Bank of England into cash held by the non-bank public. M0 measured in this way has risen by £100bn. Where the other £100bn had gone he felt would be better explained by others.

## Private sector has been far harder hit than the GDP figures indicate

### Discussion

The chairman thanked Andrew Lilico for his most thorough and thought-provoking presentation. David B Smith added that the experience of the private and public sectors of the British economy had been so divergent that it was important to analyse them separately. For example, while real GDP had fallen by an annual 5.4% in the first three quarters of last year, real private domestic expenditure had plummeted by no less than 11.7%. Likewise, he said that stripping out welfare-benefit financed consumption out of total consumption would show that underlying household consumption fell by 5.6% in the first three quarters of 2009 rather than the 3.4% contraction shown by the aggregate figure.

## Unemployment and labour hoarding

Regarding unemployment, he said that people were drawing false parallels with the experience of the 1980s and the 1990s. The main difference between then and now was that there was no longer scope for gut-wrenching job losses in manufacturing where redundant workers were highly likely to appear in the unemployment rolls. In contrast, job losses in private services had a much smaller impact on the jobless totals and the effect of changes in government jobs was weaker still. He added that another interesting issue was the extent to which high marginal rates of tax and national insurance and the system of tax credits encouraged firms to hoard workers. This was because the net loss of post-tax and post-credit income from shorter working hours was significantly less than the gross cost. The chairman then asked Patrick Minford to present his comments as he knew Patrick had to leave promptly at 6.00 pm.

## De-centralised nature of public spending makes it difficult to achieve fiscal consolidation

Patrick Minford said that there were two uncertainties. First, there was the need for fiscal consolidation. But public sector spending was largely decentralised - for example, example via universities - which made consolidation difficult to deliver in a predictable way; it is quite possible that cuts would come in faster as spending units anticipated hard times. Second, there was the banking system. As fast as the Bank of England loosened monetary policy through QE, the Financial Services Authority (FSA) instructed commercial banks to tighten through higher capital requirements. Hence the sharp fall that could be observed in broad money supply growth. It was vital that QE should be allowed to work and increase the growth of M4X. Money had to be allowed to flow to small companies. Finance had been coming available for large companies through bond and equity issuance and this had been finding its way back to the smaller companies somehow, presumably through trade credit or *ad hoc* market intermediaries. However, while finance was getting to Small and Medium-sized Enterprises (SMEs) through the backdoor, it was not doing so through an increased money supply. He concluded that QE should continue on a 'suck-it-and-see' basis. The parameters of determination should be the recovery and inflation.

**Progressive taxes mean revenue falls faster in downturns**

Peter Warburton said that the extent of the fiscal deficit was larger than expected. He wanted to pick up on the role of tax credits. He said that because the tax system was progressive there was a gearing down of revenue in a downturn. Tax credits had saved employment from falling too much. There had been a 10% increase in housing benefit claims. The extent of the transfer from the private to the public sector had been enormous. The corporate sector debt burden had been lifted so growth in investment was likely to be strong and inflation much more likely. Kent Matthews asked Peter Warburton to clarify why exacerbated inflation is likely. Peter Warburton raised significant doubts over the measurement of the output gap and its relevance to the credit-induced slump. Usable economic capacity had been reduced by the credit crisis to a greater degree than was widely realised and this had had the effect of increasing costs along the global supply chain. For given monetary conditions, the UK was likely to experience greater inflationary pressures than before.

**Tax credits act as employment subsidy**

Philip Booth said that the tax-credit system worked as an employment subsidy. The tax credits had possibly, therefore, stopped unemployment rising further, although this temporary effect does not justify them. David B Smith suggested that tax credits were working like the 1795 Speenhamland system of outdoor relief or the 'OXO' system in the 1930s, which had encouraged collusion between employers and workers to gerrymander working practices to qualify for state support. He said that the collapse in global supply chains had induced a collapse in intermediate demand that could be best comprehended in the context of an input-output model. A fall in intermediate demand appears as a destocking in conventional national accounts. One sign that supply chains were cranking up again would be when the current run down of inventories went into reverse. David B Smith added that the negative effect of a rising government spending burden on productive capacity was generally not well appreciated. He expected the growth of British productive capacity to be possibly 1½ percentage points per annum lower as a result of the aggressive re-socialisation of the UK economy over the past dozen years and that trend GDP growth would only average around 1¼% to 1½% in consequence. This meant that there was nothing like as much spare capacity as was measured by the conventional output gap.

**Domestic demand is weak. Second downturn possible**

Trevor Williams said that he did not buy the argument of rising domestic demand as mentioned by some. He said that the state of household debt, risk of unemployment, and low real wage growth is going to constrain household spending. The personal sector saving rate will rise further as the household sector continues to strengthen its balance sheet. Therefore, domestic demand will remain weak. He said that a second downturn is also possible. He asked why we should expect the saving ratio to fall - a necessary though not sufficient condition for recovery - if, as is currently the case, broad money is slowing.

**Inflation only becomes a problem if CPI feeds into wages**

Ruth Lea said that David B Smith had given a cogent explanation as to why unemployment had not risen as much as expected. She said that she agreed with Trevor Williams that there was a lack of robust expansion. She said that she was pessimistic about the prospects for growth. There were signs of recovery but its strength was uncertain. However, there was a case for a pause in QE and wait for fiscal consolidation. QE could be revisited if the economy was not seen to be growing. She said that she was unworried by inflation, which had been driven by the unravelling of base effects, Value Added Tax (VAT) and oil in the short term. Current inflation only became a worry if it fed into wages but there was little indication that this was happening. She said that she was relaxed about the dangers of inflation.

**Comments by Sunday Times observer**

The chairman then asked the *Sunday Times* observer, David Henry Smith, for his views on the current state of the economy. David Henry Smith said that the discussion about the effects of the tax credit system was interesting. One of the arguments for the minimum wage was to stop employers from exploiting the tax

credit system and get a free ride on wages. It was striking that output had fallen by 6% but employment had fallen by only 2%. It was possible that the fall in output had been overstated. He said that the labour market was a lot healthier now and referred to a recent Department of Work and Pensions discussion paper that had examined flows into and out of unemployment. In the light of the poor December inflation figures, he said there was a case for a pause in QE as the market was beginning to think that the Bank of England no longer cared about inflation. He said that he agreed with recent comments by the former Monetary Policy Committee (MPC) member Wilhelm Buiter that there should be a halt in conventional QE but that the Bank should also announce that they would be willing to purchase quality assets from the private sector. The market would produce these assets if there was a need.

### QE influences expectations

David B Smith said that one of the main roles of QE was the defensive one of neutralising the crowding out effects that would otherwise have arisen from the large budget deficit. Gilt rates would have been higher and M4X consequently even lower without it. Kent Matthews said that there had been no discussion of the effects of QE on expectations. He said that there were strong parallels with the 1930s. For the decision to come off the gold standard, read devaluation of sterling, for countries that remained on gold read EMU. The exchange rate played a pivotal role in the 1930s and we should expect the same now. Part of the sterling devaluation was due to expectations and expectations could reverse if QE was halted. He said that he favoured a new medium term financial strategy, similar to the one implemented in the early 1980s, that announced targets for a declining fiscal deficit as a share of GDP and increasing QE at a specified rate of growth.

### Votes are listed alphabetically

#### Votes

The Chairman then asked each member present to make a vote on the monetary policy response. The votes are listed alphabetically rather than in the order they were cast, since the latter simply reflected the arbitrary seating arrangements at the meeting. The Chairman traditionally voted last as at all SMPC gatherings. However, Tim Congdon's vote was subsequently cast *in absentia*, because only eight SMPC members were able to attend the 19<sup>th</sup> January gathering.

### Fiscal consolidation is necessary if QE is not to be followed by a funding crisis

#### Comment by Philip Booth

(Institute of Economic Affairs)

**Vote: Keep rates on hold. QE to be sufficient to deliver M4X growth of 5%. Fiscal consolidation necessary.**

**Bias: To end QE rapidly if and when M4X growth starts to pick up.**

Philip Booth expressed a dislike for the current terms in which QE was discussed and the amounts of QE determined. He believed that amount of QE should be sufficient to prevent M4X from falling. What this would mean in terms of further tranches would be determined on a week-to-week or month-to-month basis. He believed a fiscal consolidation was necessary if the end of QE was not to lead to a funding crisis.

### International recovery remains fragile, especially in the Euro-zone

#### Comment by Tim Congdon

(International Monetary Research Ltd)

**Vote: Hold.**

**Bias: Neutral; adjust QE to maintain broad money growth at around 5%.**

In his e-mailed submission, received on 26<sup>th</sup> January, Tim Congdon stated that the recovery remained fragile, with much of the rebound in other advanced nations since mid-2009 due to the inventory cycle rather than growing final demand. Business surveys were more or less alright for the UK at present and suggested roughly trend growth in early 2010. However, they appeared to be

losing momentum in our European trading partners. The 'Club Med' members of the Euro-zone – which accounted for about a third of its GDP – were in serious macroeconomic trouble, with no obvious escape from a deflationary black hole.

**UK monetary developments are now more encouraging, but need to be watched**

UK official policy had to be organised to sustain a positive rate of growth of M4X. Monetary developments needed to be watched month by month and were much more encouraging than in late 2008 or early 2009, but there was no doubt that banks were not in an expansionary mood at present. Bankers continued to be intimidated by new regulatory requirements (notably from the December proposals from the Basle Committee), while unused credit facilities and mortgage approvals had collapsed compared with mid-2007 and were going sideways at best. Tim Congdon was in favour of keeping Bank Rate at ½% and using pragmatic month-by-month variations in QE to keep M4X growing. One qualification was that the government's debt financing plans for fiscal 2010-11 included provision for some £70bn to £80bn of financing at the short end. This would almost certainly be taken up mostly by the banks and result in money creation.

**Need for an explicit fiscal consolidation plan**

Tim Congdon's submission added that he was worried about the possibility that the demand for loans would be reviving; possibly, in early 2011 (but who knew?). The Bank of England would then need to sell its gilts in order to fend off eventual inflationary pressures. These gilts would be likely to be sold at a loss. This was not a problem for the UK as a nation because we were all both taxpayers and bondholders via pension funds etc. But the newspapers might have another field-day of misinterpretation and alarmism. He added by emphasising that he was **not** in favour of large-scale and irresponsible monetary financing of the budget deficit over the medium term. That would be inflationary and of course he opposed it. But he remained in favour of aggressive monetisation of existing public debt for as long as banks' claims on the private sector were flat or falling. Over the medium term his prescriptions were still – as they had been for over thirty years – for growth of the broadly-defined, deposit-dominated quantity of money at a rate consistent with price stability and low inflation (i.e., about 5% in the middle, but with a band of, say, 3% to 7%) and strong public finances, focussed on the return of an approximately balanced budget. An explicit consolidation plan – as with the Conservatives' Medium-Term Financial Strategy in the early 1980s – remained not just desirable, but essential.

#### **Comment by Ruth Lea**

**(Arbuthnot Banking Group)**

**Vote: Hold. Pause in QE. Fiscal consolidation necessary.**

**Bias: Towards further easing.**

**Bank should pause with its QE programme to maintain anti-inflationary credentials**

Ruth Lea said that the recovery looked very uncertain and, even though she was not worried about inflationary pressures picking up, she felt that the Bank of England should pause with QE as any expansion now might give the markets the impression that it was no longer serious about meeting its inflation target. Later in the year, when more should be known about the speed and extent of the fiscal consolidation process, the Bank could offset further fiscal tightening with more QE if it was considered appropriate.

#### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: Hold. Pause with QE. Fiscal consolidation is necessary.**

**Bias: Hold Bank Rate over next three months, although rates will rise later this year; extend QE again from August 2010.**

**QE cannot continue indefinitely**

QE cannot continue indefinitely. The next six months, which will probably see positive GDP growth, are a good moment for a pause, while holding back a

further additional large tranche of QE to be used in co-ordination with the large fiscal tightening that there is to come.

#### Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

**Vote: Hold. Increase QE by £50 billion. Implement targeted fiscal consolidation.**

**Bias: Neutral.**

#### Targeted fiscal consolidation

Kent Matthews said that he favoured a targeted approach to fiscal consolidation to accompany a targeted increase in QE that produces a rise in broad money growth of 5% a year.

#### Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

**Vote: Hold.**

**Bias: Neutral on Bank rate; add another £50bn of QE after February.**

#### Add another £50bn to stock of QE

Patrick Minford stated that his vote was for interest rates to stay low around current levels and for QE to continue at roughly its present rates of flow, with no bias. This would mean a renewal of the currently available stock of QE by another £50bn in the near future.

#### Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

**Vote: Raise Bank Rate by ½%. Pause QE.**

**Bias: Wait and see; fiscal consolidation essential to maintain monetary credibility.**

#### Monetary policy decision cannot be separated from the adverse fiscal background

David B Smith commented that, just as it had been foolish to separate the Bank's regulatory and debt management responsibilities from its rate setting role in 1997 – because all three functions fed back on each other – it was equally misguided to believe that monetary policy and fiscal policy operated in self contained boxes. Monetary policy decisions could not be made in a vacuum, irrespective of the wider fiscal background. The decision to increase public spending further in the December *Pre-Budget Report* was feckless in the extreme and had damaged the credibility of all British policy makers. The likelihood that political pressure ahead of the election will lead to an even worse fiscal deterioration suggested that the Bank now needed to disassociate itself from any suspicion that it was underwriting a pre-election giveaway. Otherwise, it would lose the respect of the foreign exchange and bond markets.

#### Accelerating inflation will lead to an inappropriate cut in the real rate of interest if Bank Rate does not go up

By chance, the December 2009 CPI inflation rate of 2.9% was the same as the figure in March 2009, when Bank Rate was originally set at ½%. However, inflation was then receding but is now clearly accelerating, even before the return of VAT to 17½% has appeared in the figures – which will happen next month. The annual increase in the 'double-core' retail price index, which is the most historically consistent UK inflation measure, accelerated from 3% in November to 4.1% in December. Leaving Bank Rate unchanged at ½% in the face of rising inflation would imply an unwarranted cut in the real rate of interest. These were uncertain times and it was important to be flexible. However, an immediate ½% hike in Bank Rate to 1% seemed the right decision. Pausing QE until after the election also seemed appropriate, if the Bank wanted to maintain a reputation for political neutrality. Both decisions could be reversed after the election, if needs be, without doing any permanent harm, whereas a loss of monetary policy credibility would take years of stringency to rectify. He remained of the view that it was lunacy to persist with QE while the regulatory authorities were imposing restrictions that could only lead commercial banks to: 1) contract their balance sheets, and hence M4X; and 2) hold more government debt within the reduced assets book and so extend less credit to the private sector.

**UK economy particularly vulnerable to inflation**

**Recovery will be anaemic and monetary policy can safely stay loose**

### **Comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: Interest rate to rise by ½%. QE to be extended by £25bn. Fiscal consolidation is urgently required.**

**Bias: To tighten.**

As December's inflation report amply illustrated, the UK economy has a particular vulnerability to inflationary pressures. Disruptions to the global supply chain have penalised countries like the UK, which have suffered significant currency depreciation since the crisis erupted in 2007. UK inflation expectations over the medium term are creeping higher and may have already detached from the MPC's inflation target. With the headline CPI inflation rate likely to exceed 4% within a few months, implying materially negative real interest rates, there is an urgent need for the MPC to normalise bank rate towards the 2% to 3% range. My vote is for an immediate ½% increase in Bank Rate. Nevertheless, it is appropriate to extend QE by another £25bn to help smooth the adjustment to higher yields in the gilt market.

### **Comment by Trevor Williams**

**(Lloyds TSB Corporate Markets)**

**Vote: Hold: increase QE by £50bn.**

**Bias: To hold.**

Trevor Williams said that he expected the economic recovery to be anaemic and possibly to stall in the first quarter. What was being seen was a minor technical bounce after a sharp downturn, not a sustainable pick-up. There was a serious risk of a relapse in the recovery if QE is withdrawn at this stage. The rise in CPI inflation should be ignored, as it is a change in the price level, not inflation. With flat domestic demand, plenty of spare capacity and no growth in private sector earnings, UK inflation will fall back to below 2% in the next eighteen months. Hence, there is no reason why monetary policy cannot stay loose.

### **Policy response**

1. A seven to two majority of the shadow committee felt that Bank Rate should be held at ½% in February. The two dissenting members wanted an immediate ½% rise in Bank Rate to 1%.
2. A majority of the SMPC felt a policy of fiscal consolidation needed to be put in place and two members advocated a revived Medium-Term Financial Strategy.
3. Three members of the shadow committee said that there should be a pause in QE after the current programme expires this month; four members wished to extend QE beyond February, with three specifically requesting an additional £50bn; and two SMPC members believed that the amount of QE should be determined pragmatically in the light of the behaviour of M4X.

### **Date of next meeting**

Tuesday 20 April 2010

## **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.

### **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: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), 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), Peter Spencer (University of York), 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 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  
pippa@lombardstreetresearch.com