

Minutes of the Meeting of 20th April 2010

Attendance: Philip Booth (IEA Observer), Roger Bootle, Tim Congdon, Ruth Lea, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David Brian Smith (Chair), Peter Warburton, Trevor Williams, External observers Hiroshi Oka (Minister for Economic Affairs, Embassy of Japan), and Hajime Yoshimoto (Senior Economic Analyst, Embassy of Japan).

Apologies: John Greenwood, Gordon Pepper, David Henry Smith (*Sunday Times* observer), Peter Spencer and Mike Wickens.

Chairman's comments

Postponed Bank of England rate decision

David B Smith commenced the meeting by stating that the Bank of England's May rate decision would be announced at noon on Monday 10th May, rather than the Thursday 6th May that had originally been intended, because of the forthcoming general election. He thought that the SMPC should stick to its normal publication schedule and not take advantage of the delay to publish a week later than normal, however. This was partly because there would be little hope of gaining any media coverage if the SMPC report was released immediately after the election. He then called on Peter Warburton to provide his analysis of the global and domestic monetary situation.

The Monetary Situation

International monetary growth remains weak but other evidence suggests scope for upside surprises

The International Situation – Global activity indicators rebounding

Peter Warburton referred to his prepared slides on the *Briefing for Shadow Monetary Policy Meeting*. (*Editorial note: these can be obtained from rosa@economicperspectives.co.uk.) He then referred to the chart of the fifty-country-weighted average of broad money growth in the world as a whole, which showed a sharp deceleration since late 2008. The two-year average also continued to show a downward trend. A separate chart of broad money growth in the US showed negative growth. Other charts show Japanese broad money growth picking up but China's broad money growth - which had been rising - was likely to fall with the expected property market correction. India has raised its official discount rate but money growth continues to be high but stable. However, global activity indicators have seen a sharp rebound with China showing a strong recovery accompanied by reckless capital spending. Peter Warburton then warned that simple comparisons with previous recessions might be dangerous. Charts of nonfarm payrolls, US GDP growth and industrial production showed the insipid nature of expectations. However, other indicators suggest that there may be an upside surprise on growth. The ratio of free cash flow to GDP of non-financial businesses in the US and Northern Europe is running at a forty-year high, leaving the corporate sector less dependent on external sources of finance. With businesses in G-7 countries contemplating a fall in their net capital stock this year, there is an imperative to reinstate capital expenditure and rebuild inventories. The view of the International Monetary Fund (IMF) was that a large part of the fiscal deficits being observed in many of the leading economies was structural not cyclical. Emerging demographic issues compounded the deficit problem. Consumption figures in the Euro-zone had shown a flicker of revival and measures of global trade and other consumption indicators were normalising.*

The UK Economy – decelerating money growth but potential for surprise growth in output

Consensus forecasters will be surprised by the rebound

Referring back to the charts, Peter Warburton said that the UK was also experiencing a sharp monetary deceleration that was driven by the wholesale deposits element of broad money. But there were also indicators of an upturn in British activity that could come as a surprise to consensus forecasters because of the potential sharpness of the rebound. The Consumer Price Index (CPI) measure of inflation had risen to 3.4% in March and the old RPIX target-measure was up 4.8% on the year. Stripping out base effects from the March

2009 data, together with mortgage rate and energy effects, suggested that underlying inflation was now of the order of 4% to 5%. This suggested that the pass-through from the downwards exchange rate movement had been rapid and that inflation was likely to prove sticky downwards.

Recovery in global intermediate demand could lead to an inventories surge and leave monetary authorities 'behind the curve'

David B Smith thanked Peter Warburton for his presentation and added that the usually reliable longer-leading indicators produced by the Organisation of Economic Co-operation and Development (OECD) were showing signs of strong improvement, as were the relatively new indicators for the Euro-zone and Britain produced by the US Conference Board. He then suggested that one reason for expecting a rebound in global activity, even in the face of weak monetary growth, was that intermediate demand, which does not appear in the conventional national accounts, may be bouncing back now that global supply chains appeared to be cranking up again. The earlier collapse in global intermediate demand had resulted from the surge in perceived counter-party risk that followed the Lehman's collapse. The reversal of this phenomenon would appear as a surge in inventories in conventional national accounts, at which point the monetary authorities might decide that they were 'behind the curve'. David B Smith then invited Patrick Minford to record his comments as he knew that Patrick had to leave the meeting early.

Discussion

Fiscal tightening and QE to increase broad money growth

Encouraging upside activity creates hawkish sentiment

Patrick Minford said that he agreed with Peter Warburton's assessment that activity was surprising people on the upside. Despite the deceleration of M4, weak bank lending, and the banking crisis, spreads have narrowed and firms have obtained finance from other sources. The positive news has made him feel more hawkish. The Financial Services Authority (FSA) was making matters hard for the banks and fiscal correction would have to take place but he would not like to see any change to the current stance of policy. Bank Rate should stay at its current level for the time being but he then had a bias to rise.

Regulatory attack on banks risks creating an implosion of money and credit and...

Andrew Lilico asked if Peter Warburton saw any scenario that resulted in a contraction in 2010. Peter Warburton said that the problem was that real disposable income was expected to contract this year and the next; therefore consumption growth would be zero. Net exports and investment would have to take up the slack for growth to be sustained. Tim Congdon said that the FSA was only part of the problem. Banks are not growing their balance sheets because they are under continuous regulatory attack. The business of discouraging financing from the wholesale markets had constrained the banks from offsetting the contraction in broad money. Tim Congdon then emphasised that the USA's adoption of Keynesian fiscal expansion, with the Federal deficit moving out to \$1,400 billion, had so far failed to bring down unemployment. In his view, this disappointment demonstrated - yet again - that fiscal policy was an inefficient and unreliable means of influencing economic activity, and that money growth and banking developments were far more important. Andrew Lilico said that the expectation was the 'Basle III' regulatory changes currently under discussion would require capital ratios to be closer to 16% of risk-weighted assets. Banks were likely to reduce asset growth and use profits to raise capital rather than expand their lending books in consequence.

...there are many negative indicators

Roger Bootle said that he was surprised by Peter Warburton's and Patrick Minford's positive assessment. He said that there were many negative indicators including the problems of the banking system. The problems were international and not temporary. Growth will be low in the Western economies. The fiscal correction will eventually have negative effects on activity with job losses in the public sector but there would be no fiscal contraction this year. In the Euro-zone, there would be enforced deflation. The prospects for China-US trade remained in a dangerous situation, in Roger Bootle's opinion. Andrew Lilico added that he also foresaw considerable downside risks. Unemployment was a lagging

indicator. There were also risks associated with the Euro-zone and the financial sector remained in an unstable state, both at home and overseas. However, fiscal contraction was likely to be expansionary on the Ricardian equivalence argument. OECD studies had shown that fiscal consolidation can be expansionary.

Significant fiscal consolidation unlikely this year

Ruth Lea said that she agreed with Roger Bootle that a significant UK fiscal consolidation was unlikely to occur this year. Even a Conservative government with a clear majority would only implement a muted consolidation in 2010-11. The outlook for UK exports was also damped by the current and prospective weakness of its trading partners in Continental Europe. Euro-zone problems were only partly those of the 'PIGS' (Portugal, Italy, Greece and Spain). The main driver of the Euro-zone economy, Germany, also remained weak.

Reversal of QE would be a major contractionary force

Trevor Williams said that growth appeared to be picking up in the emerging markets but global growth was still not self-sustaining. Broad money was still contracting in Germany. A reversal of Quantitative Easing (QE) by the Bank of England would have a major contractionary effect on the economy. Bank finance remained important for Small and Medium-sized Enterprises (SMEs) but balance sheets would contract, reducing the potential for future growth. A closer examination of the unemployment statistics showed that the labour market remained depressed. Inflation had not risen by even more because of the slack in the labour market. Trevor Williams agreed with the previous speakers that the sluggishness in the Euro-zone weakened the potential for export led growth in Britain.

Fiscal consolidation issues

Roger Bootle said that business investment would not occur in the face of strong excess capacity. Peter Warburton disagreed and said that businesses do not view investment potential in the same way as macroeconomists do. The potential for profitable investment is large and the faster potential pay back is the main driving factor. Kent Matthews said that he agreed with Andrew Lilico's view that a so-called 'contractionary' fiscal policy might prove expansionary under the right circumstances. In particular, the Ricardian-equivalence argument had force if fiscal contraction was planned and announced in advance so that expectations of a lower future tax burden - than would otherwise have been the case - could take root. A policy of immediate slash and burn was not credible hence the need for a considered but credible set of targets.

The need for a revived MTFS

Kent Matthews added that the person who turned out to be the Chancellor after the election should announce the equivalent of a 1980s type of Medium-Term Financial Strategy (MTFS). This revived MTFS should announce targets for a declining fiscal deficit expressed as a percentage of Gross Domestic Product (GDP) accompanied by sufficient QE to raise broad money growth to a specified rate. After some discussion, it was agreed by Tim Congdon and David B Smith that this indicative growth rate for UK broad money should be around 5% to 8% annually, if the M4X broad money definition was taken as the appropriate measure.

Votes

Votes are listed alphabetically and...

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.

...there were no votes in absentia

Because nine members of the shadow committee had been present at the meeting there was no need for votes in absentia, and Philip Booth was not awarded a vote, despite his attendance at the gathering. The Chairman traditionally votes last, so as not to influence the votes cast by the other members of the shadow committee.

Comment by Roger Bootle

(Deloitte and Capital Economics)

Vote: Keep rates on hold. Increase QE by a further £50bn in the short term.

Bias: to ease.

Economy remains fragile and...

Roger Bootle stated that the economy remained very fragile and that it had to face headwinds coming from several different quarters. After the election, there would have to be a major fiscal contraction, whoever won. Even if not much was enacted in the immediate future (and Roger Bootle believed that a rise in VAT to 20% was likely very soon) the whole popular climate of expectation about the future financial position would be transformed. There was a seductive view held by believers in Ricardian equivalence, amongst others, that such fiscal tightening could take place without damaging aggregate demand, or might even strengthen it. Roger Bootle was extremely sceptical.

...unemployment could rise as job losses in the public sector add to private redundancies

Moreover, he was concerned that unemployment would continue to rise as a result of job losses in the private sector, soon to be added to by losses in the public sector. The weakness of the world economy, and particularly our main markets on the continent, implied that the recovery of exports would be sluggish. Meanwhile, banks would remain reluctant to lend. Inflation was set to plummet in the second half of this year. Although there were widespread inflationary fears they were misplaced. The rate of growth of average earnings gave the key. And there was virtually no sign of wage inflation anywhere outside the public sector.

Comment by Tim Congdon

(International Monetary Research)

Vote: Hold. And continue with QE.

Bias: Neutral.

Use QE to sustain broad money growth

Tim Congdon said that the budget deficit must be reduced. His recommendation was to reverse fiscal policy and continue with QE consistent with a return to broad money growth of around 5% to 8%.

Comment by Ruth Lea

(Arbuthnot Banking Group)

Vote: Hold. Wait and see on QE.

Bias: Neutral.

Regulatory dangers and need for fiscal tightening

Ruth Lea said that the proposed regulatory changes to the banks could have serious consequences for bank lending. Major fiscal tightening will be necessary. There are doubts about the strength of the recovery. She said that she was not, on the whole, worried about inflation.

Comment by Andrew Lilico

(Europe Economics)

Vote: ¼% rise. Restart QE.

Bias: Tighten.

Risk of 'double-dip' recession

Andrew Lilico said that he remained pessimistic about the immediate future and that he expected a double dip in the second and third quarters of 2010. However, he also felt that investment-driven growth and greater confidence associated with significant spending cuts might make 2011 a bumper year. He advocated fiscal tightening accompanied by a further £200bn of QE. Andrew Lilico also felt that Bank Rate needed to rise as a signal to the Gilt-edged market that there will be a determined and sustained effort on spending cuts and QE expansion.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Hold. Increase QE £50 billion. Targeted fiscal consolidation.

Bias: Neutral.

Too early to raise interest rates

Kent Matthews said that it was too early to start raising interest rates. He favoured a planned fiscal tightening and further QE to generate growth in the money supply.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Hold.

Bias: Tighten.

Tight raw material supplies limit scope for recovery

The situation is one of slow recovery, with most indicators pointing upwards. Faster recovery would be difficult in the present environment of tight raw material supplies and already high prices. Monetary indicators of capital costs to the private sector show costs have fallen and finance is now being raised as needed it seems, in spite of bank credit growth stalling. Further QE now looks unnecessary and the next move in Bank Rate may need to be upwards. However, the fiscal tightening that is due post-election, with or without a hung Parliament, means that interest rates will need to stay fairly low even if they can rise from close to zero.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Raise Bank Rate by ½%; hold QE stock at present level.

Bias: Fiscal consolidation is necessary for any private sector recovery. Bank Rate decisions should depend on post-election fiscal background.

Labour plans to spend 54% of UK factor-cost GDP next year

David B Smith said that the outlook was clearly clouded by political uncertainty, even if it was not appropriate for the SMPC or the Bank of England, for that matter, to become involved in the party-political debate. He added that it was also important to distinguish between what was happening to the government and the private sectors now that they accounted for roughly equal shares of national output. A government sector accounting for 54% of the factor-cost measure of GDP – which is Labour's intention for fiscal 2011-12 - has serious long-term supply side implications. In particular, the sustainable annual growth rate of the British economy may be no more than a euro-sclerotic 1¼% to 1½% as a consequence rather than the 2¾% assumed by the politicians. There was also strong evidence from simulations on macroeconomic models and reduced-form 'multiplier' equations that both higher taxes and – perhaps, more surprisingly - budget deficits completely 'crowd out' at least as much private expenditure within three or four quarters.

Private sector activity fell by far more than is suggested by 'headline' GDP last year

Last year's 4.9% fall in UK real GDP masked the extent to which the private sector had been hammered in 2009, when the volume of non-welfare financed household consumption had fallen by 5.7%, private capital formation had plummeted by 19.4%, and total real private domestic expenditure (including inventories) had dropped by 10.8%. The need now was to succour the non-socialised part of the economy by controlling spending and freezing the tax burden, not to pour more resources into the public spending juggernaut. David B Smith was pessimistic about the willingness and/or ability of politicians from all three major parties to deliver the necessary fiscal tightening, however. A not unlikely 'worst-case' scenario was that a misguided and internationally co-ordinated regulatory shock to the banking system would create a collapse in global money and credit and induce a vicious second leg to the downturn. His view was that Bank Rate should be raised to 1% immediately - but he had an open mind thereafter - and that the Debt Management Office (DMO) should be

re-integrated into the Bank of England so that funding policy and Bank Rate setting could be employed in a mutually reinforcing way.

Generational accounting shows UK government has more 'off-balance-sheet' liabilities than other nations

Finally, David B Smith drew attention to the extent of British government's future off-balance sheet liabilities as revealed by generational accounting methods. This long term threat has not found its way into the political debate. However, recent research by economists from the University of Freiburg shows that the UK was in the worst position amongst the developed economies with a 'fiscal gap' equivalent to 547.2% of GDP (with explicit debt of 37.2% and implicit debt of 510% of national output) using the most recent 2004 data compared with: 408% in the US (explicit 57.1%/implicit 350.8%); 315.3% in France (60.4%/254.9%); 315.1% in Germany (62.5%/252.8%); and 120.1% in Switzerland (55.2%/64.8%). Somewhat surprisingly, the lowest ratio calculated by the Freiburg economists was the 80.8% in Spain (explicit debt 45.4%/implicit 35.4%) where there are unusually low pension obligations to females for reasons going back to the Franco era. The widespread deterioration in the structural fiscal position since 2004 suggests that these figures now err on the side of optimism. They also cast doubt on whether the debt obligations of the British and US governments should be considered 'investment grade' for much longer (*Editorial note: the paper concerned is [Public Debt and Demography – An International Comparison Using Generational Accounting](#), by Christian Hagist, Stefan Moog, Bernd Raffelhuschen, and Johannes Vater, CESifo Dice Report 4/2009 www.ifo.de*).

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: ½% rise. Contingent QE of £50 bn.

Bias: Tighten.

The UK economy can cope with a 2% Bank Rate

Peter Warburton said that he expected economic growth to exceed consensus forecasts this year. He said he was confident that an interest rate rise to even 2% would not disturb the immediate outlook. He said that a message has to be sent to the gilts market that the Monetary Policy Committee (MPC) acknowledges the inflation risks of accommodative policies. An extra £50bn of QE should be set aside as a contingency.

Comment by Trevor Williams

(Lloyds-TSB Corporate Markets)

Vote: Hold. QE is an option to offset fiscal tightening in context of low official interest rates.

Bias: Neutral.

Fiscal and monetary policy concerns

Trevor Williams said that he was concerned about policy. A premature rise in Bank Rate could spark off another wave of bankruptcies. The employment situation was not good, and certainly not as benign as it appeared on the surface. Fiscal policy needed to tighten but not immediately. In the long run, public sector borrowing must fall so that room for private sector expansion is allowed. However, and in the short term, the economy will remain weak, leaving scope for loose monetary policy to act as a partial offset to tighter fiscal policy.

Policy response

1. A six to three majority of the shadow committee felt that Bank Rate should be held at its present ½% on Monday 10th May.
2. Two SMPC members wanted to raise Bank Rate by ½% to 1% in May, while one preferred a ¼% increase.

3. Eight out of the nine members of the committee felt that a policy of fiscal consolidation should be put in place.
4. Six SMPC members voted to either extend, or be on stand-by to extend, QE in a supportive role while three members thought that the existing stock of QE probably would not need to be increased.

Date of next meeting

Tuesday 20th July 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 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.

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