

Should the UK adopt Money GDP targets?

Year 2, Lecture 2

Douglas McWilliams

Mercers School Memorial Professor of Commerce

Gresham College

19 November 2013

Objectives

- To discuss how the optimal monetary policy regime for an economy like the UK has to change to take account of the impact of globalisation

Outline

- The state of the UK economy
- What has driven the economic recovery
- An assessment of QE
- The exit problems for QE
- Inflation targeting and forward guidance
- Money GDP – an idea whose time has come
- Practical problems with targeting Money GDP

Background

- 'Supercompetitive' emerging economies
- Lack of competitiveness of Western economies and difficulty in correcting this through devaluation
- Boost to inflation from upward pressure on commodity prices and devaluing currencies
- So growth shortfall and upward pressure on inflation likely
- Meanwhile, skills and capacity are partly a function of past growth and so past slow growth will have eroded capacity

The Bank admits to being 'surprised'

Chart 6: Economic 'surprise' indicators^(a)



Sources: Bloomberg and Bank of England calculations.

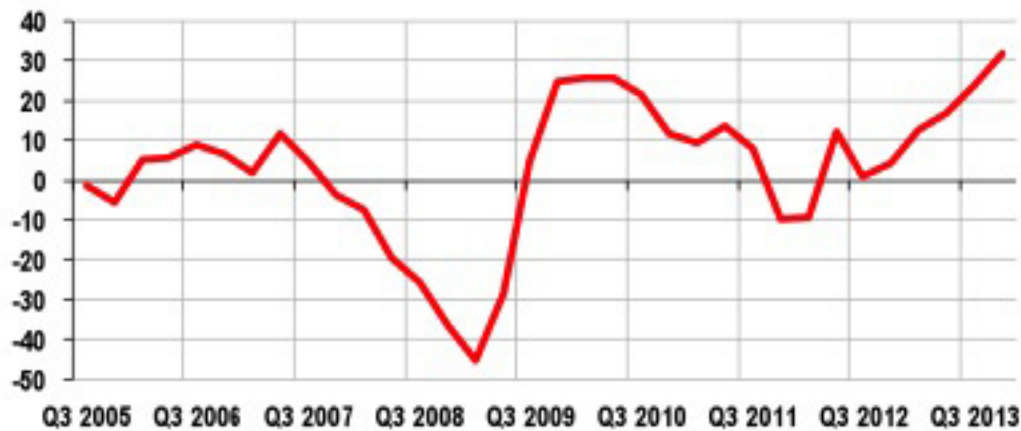
(a) Moving average of unweighted data surprises over a 60-day rolling window. Data surprises for each variable are scaled by the historical standard deviation of surprises for that variable. Variables are selected according to the number of Bloomberg alert subscriptions, but data on consumer prices, producer prices and wages are excluded.



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Rising business confidence drives the UK economy

ICAEW/Grant Thornton Business Confidence Monitor – Confidence Index



BDO LLP Business Confidence Index



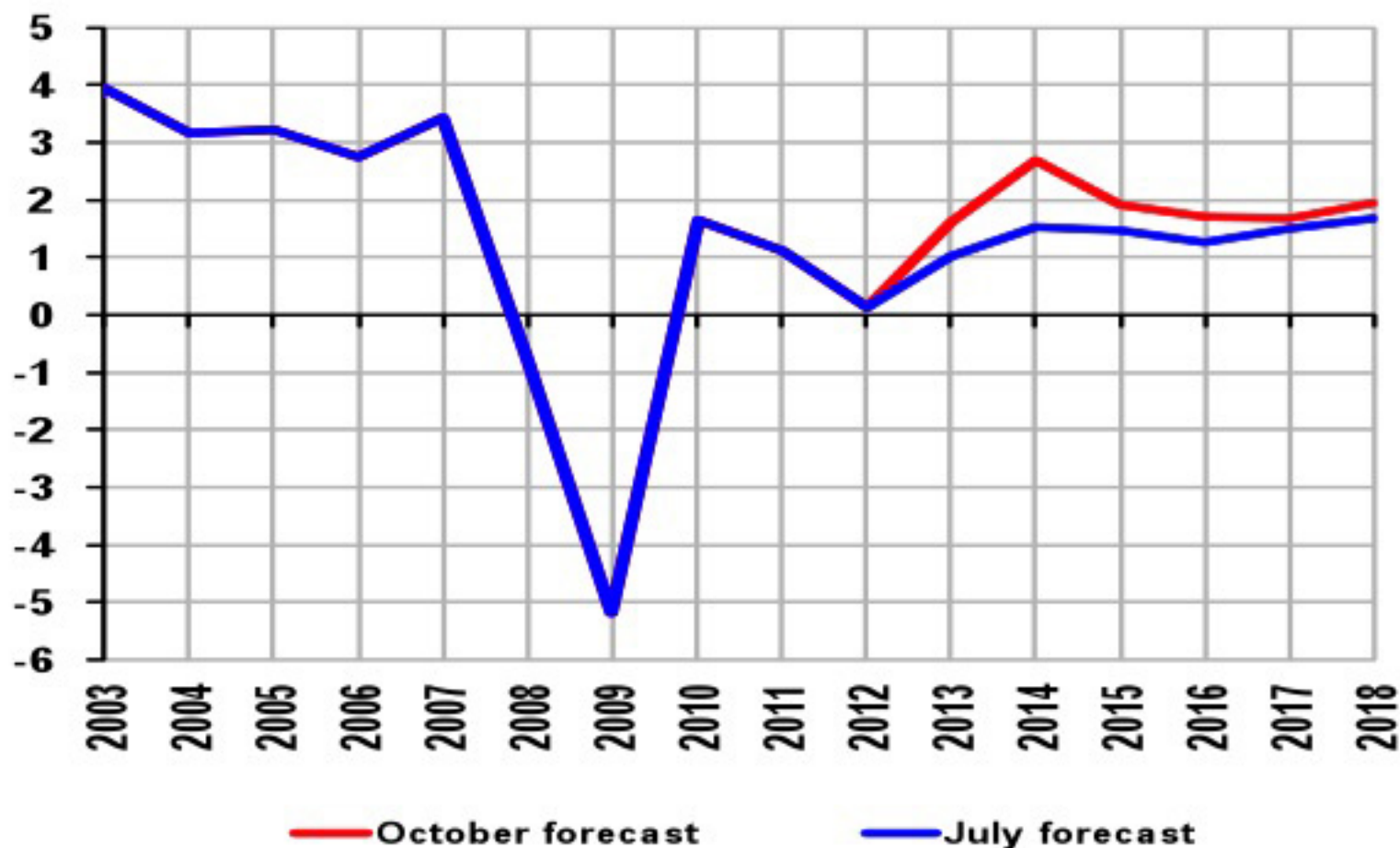
Consumer confidence has risen sharply

YouGov/Cebr HEAT Index – consumer confidence measure



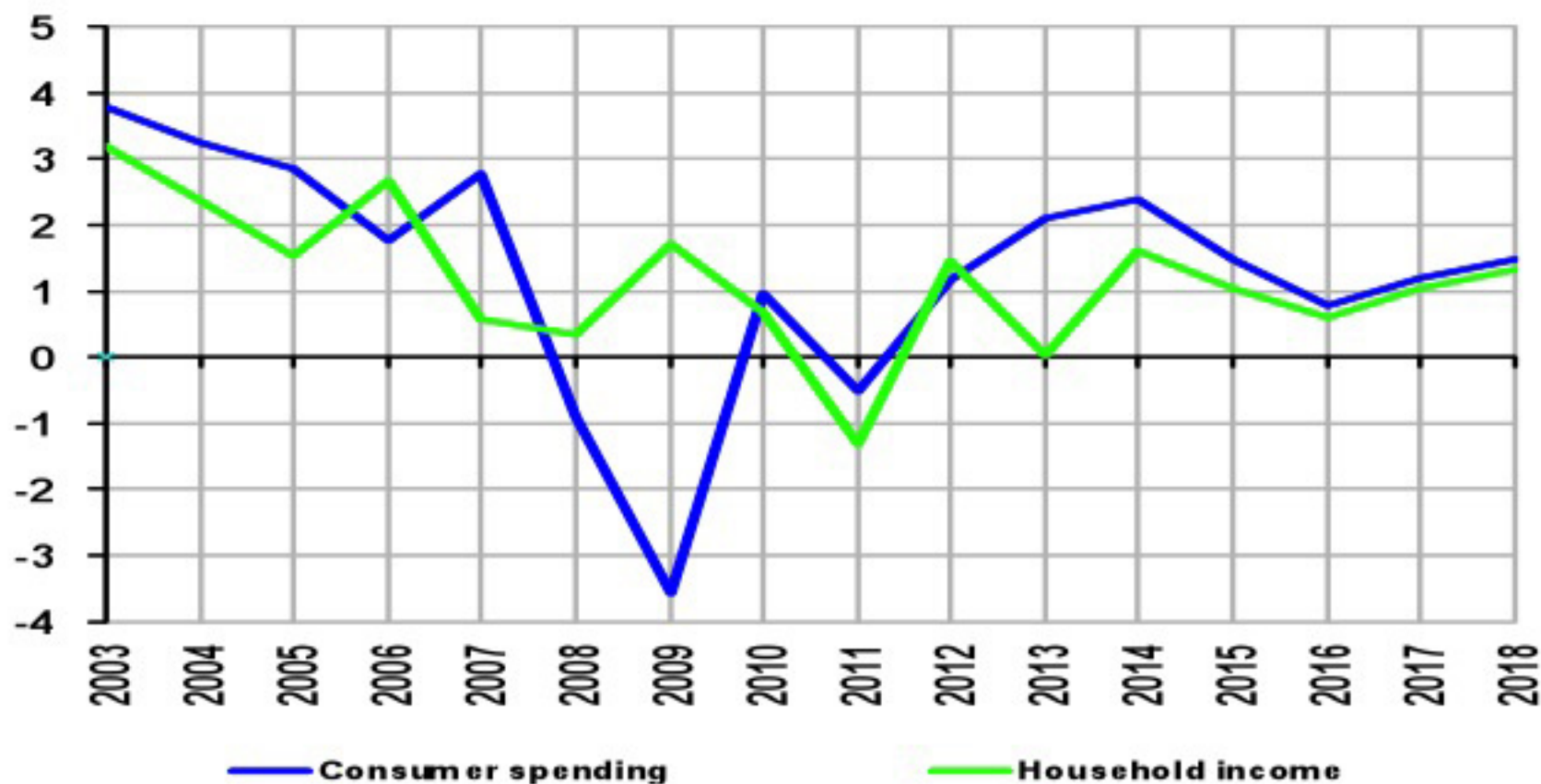
UK growth to accelerate in 2014 and then fall back

Real gross domestic product, annual percentage change



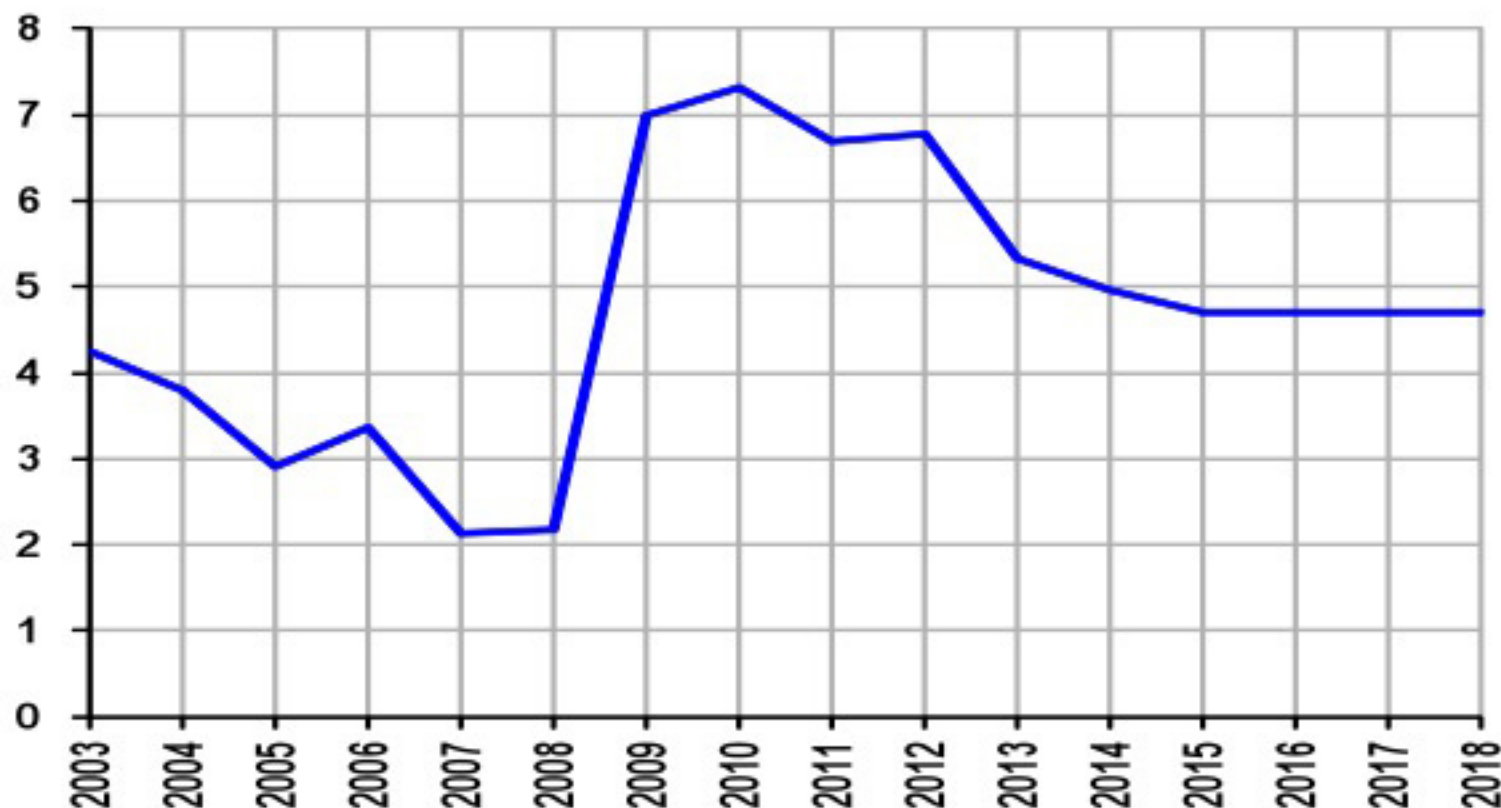
A significant gap between spending and income growth has re-emerged

Real consumer spending and household disposable income, annual percentage growth



Saving ratio to fall but remain elevated relative to pre-crisis levels

Household saving ratio, percentage





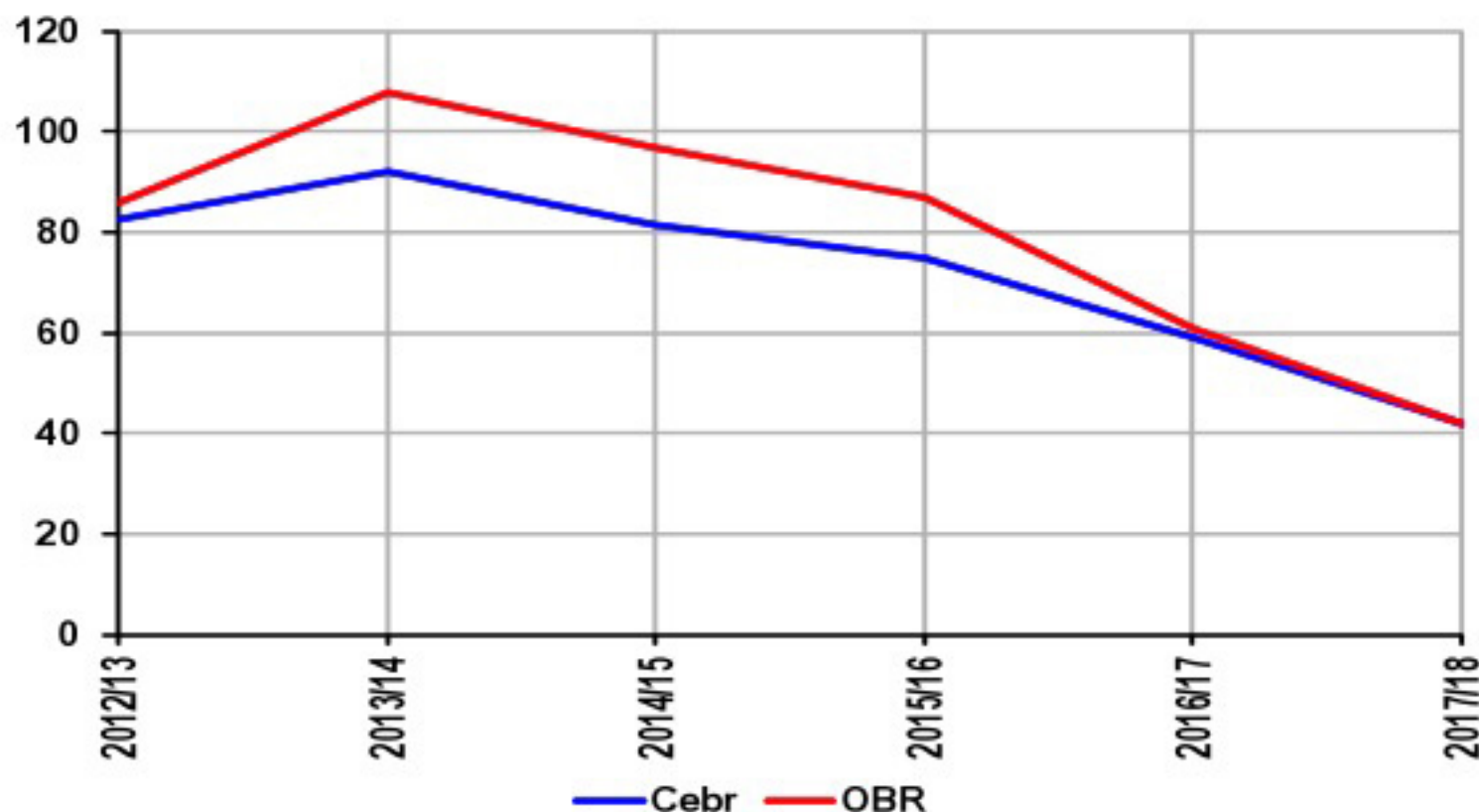
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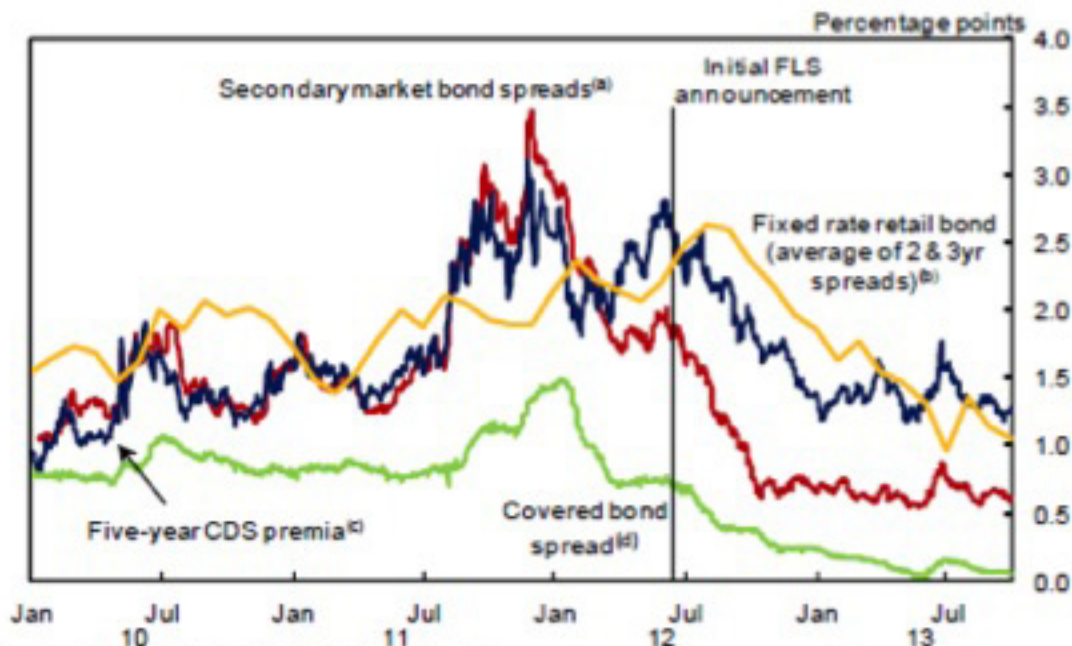
Improved growth outlook suggests borrowing will outperform OBR targets

UK public sector net borrowing, £ billions



Since Funding for Lending was announced banks' spreads have fallen

Chart 4: Indicators of bank funding spreads



Sources: Bloomberg, Markit Group Limited, Bank of England and Bank calculations.

(a) Constant-maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro senior unsecured bonds.

(b) Sterling. Spread over the relevant swap rate for fixed-rate retail bonds.

(c) Unweighted average of the five-year senior CDS premia for the major UK lenders.

(d) Constant-maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro-denominated covered bonds, where available.



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QE has been a success but the medicine is powerful and addictive

- The property market upturn and the fall in the cost of borrowing has been closely correlated with the rise in confidence
- These are directly attributable to the combination of QE and the Funding for Lending Scheme
- The rises in business and consumer confidence have been (unusually) the drivers of the recovery
- But getting out of QE will be difficult
- And the cost will not be clear until then

‘Forward guidance’

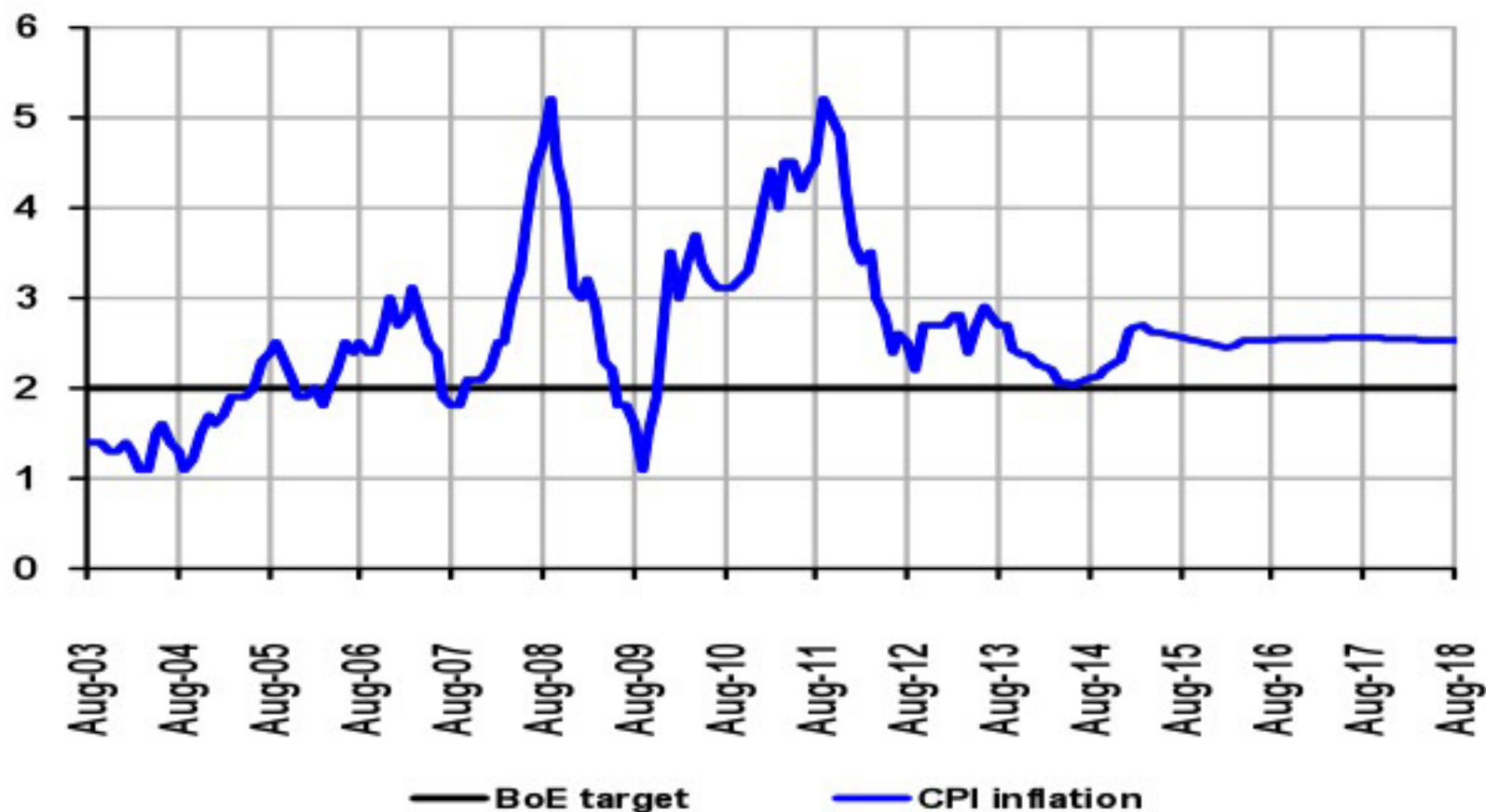
- A commitment by the Bank of England not to raise Bank Rate until unemployment had fallen to 7.0%
- Subject to various escape clauses in the small print
- Issued in August, when it was expected that unemployment would reach 7.0% in 2016
- But already it looks more likely that it will get there in 2014 and possibly early in that year

Money GDP targeting

- Put forward by Nobel laureates James Meade and James Tobin
- Promoted most actively by eminent UK economics commentator Sir Samuel Brittan
- Target for Monetary Policy Committee is the rate of growth in cash terms of GDP rather than as now a target for inflation
- Allows some flexibility for a world where the growth trend is subdued and there are upward pressures on inflation

Inflation has been above target for most of the past 8 years

Consumer price inflation, annual percentage change



Implications

- We need to ensure that the recovery isn't derailed by excessive inflation
- Meanwhile, the Chinese savings surplus still means that there is a glut of money worldwide which will keep down the interest rate trend
- We are looking for Bank Rate to average 3% through the next economic cycle
- Mortgage and other spreads should narrow
- But the case is building up for an early move in interest rates



If you want more contact:

Douglas McWilliams
dmcwilliams@cebr.com
+44 207 324 2860