

MPC in 1970s groove.

Recent news indicates that several MPC members are leaning towards supporting Adam Posen's call for an expansion of QE. With inflation forecast to remain above the letter-writing threshold until the second half of 2012, the doves are unlikely to be able to obtain majority support for action. Instead, their motivation in raising the possibility seems to be to encourage further downward pressure on the exchange rate, which they view as necessary for economic "rebalancing". This is a dangerous strategy that threatens to push sterling into free fall while destabilising the gilt market.

The assault on the pound was led by the unlikely figure of the Bank's Executive Director for Markets, Paul Fisher, who told the Daily Mail in an interview at the start of June that he would vote for more QE if the economy deteriorated, even with inflation at 4.5%. Minutes of the June meeting released in the middle of the month revealed that at least one other MPC member shared Mr Fisher's bias, in addition to the overtly-dovish Dr Posen. The grouping may include the Governor and David Miles, based on recent statements. The decision by these members to "come out" had the desired effect, with the effective exchange rate falling by 3.0% over the course of the month.

The timing of the doves' initiative probably reflects recent soft economic data – distorted by the additional April bank holiday – and Eurozone sovereign debt woes, which have temporarily displaced high inflation from the headlines. Fundamentally, they seem to be motivated by two considerations. First, they believe that the inflation overshoot is more than explained by a combination of the VAT hike and large increase in energy and import prices – domestically-generated inflationary pressures, in other words, are negligible. This view is reflected in a chart in the February and May Inflation Reports showing a range of estimates for the level of CPI inflation excluding the contribution of VAT and energy / import prices. This range was -0.5% to 1.3% in February and fell to -0.9% to 1.0% in the May Report.

The implication of this view is that a further surge in import prices that would follow from additional sterling weakness, far from being a development that the MPC should seek to avoid, is actually necessary to prevent inflation from falling below the target.

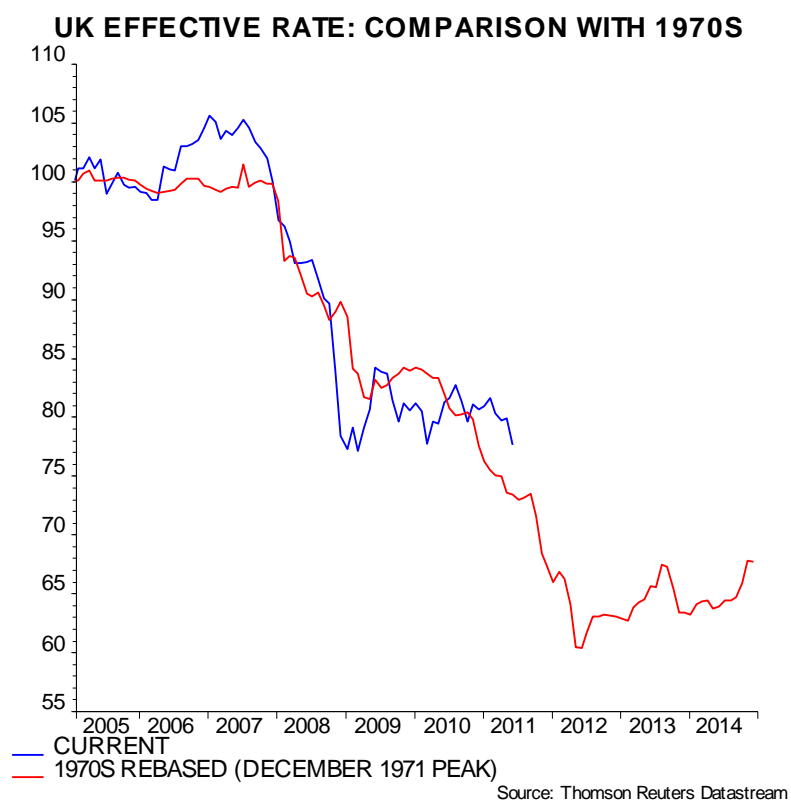
Secondly, the doves expect fiscal tightening and private-sector deleveraging to weigh heavily on domestic demand, implying that achievement of respectable GDP growth depends on a large improvement in net exports. As Mr Fisher put it in his Daily Mail interview, "zero consumption puts a very heavy burden on the export side to deliver". The doves have been disappointed by the lack of trade response to the 25% fall in sterling's effective rate since the middle of 2007, notwithstanding better first-quarter numbers, and appear to believe that further depreciation is required to allow UK firms to gain market share.

These two arguments are, at least in the view of the author, weak. Any attempt to calculate what inflation would be "without the bad stuff" is highly speculative. The deflator for GDP at basic prices is a direct measure of domestically-generated inflation, excluding tax effects – it rose by 2.0% in the year to the first quarter, contradicting the doves' view that the target would have been undershot but for various "shocks". If energy and import costs had remained stable, moreover, consumers would have been able to spend more on other goods and services, pushing up their prices. Inflation would probably still be above target, driven by a stronger domestic component.

The claim that net exports must bear the burden of growth is similarly suspect. Domestic demand actually rose by a solid 4.2% in cash terms in the year to the first quarter. This, however, translated into a real increase of only 0.5% because of high inflation, for which the Bank bears partial responsibility. It is, in any case, doubtful that the tradeables sector – and particularly manufacturing – is capable of becoming the "engine" of growth, as the doves desire. In the April CBI industrial

trends survey, the percentage of firms citing a shortage of plant capacity as a constraint on output was the highest since 1988. Under these circumstances, a further fall in sterling is likely to be reflected in higher prices rather than an increase in export or production volumes.

Current monetary policy is reminiscent of the mid 1970s, when the authorities similarly allowed a large gap to open up between inflation and official interest rates. Sterling had stabilised in 1974 following a large decline in 1972-73 but embarked on a second leg down as real interest rate support disappeared. The slide was arrested only after a large rise in official rates during 1976 and a bail-out loan from the IMF. The gilt market, unsurprisingly, sold off sharply into the exchange rate trough. The chart overlays the path of the effective rate in the 1970s on recent performance. Sterling has traded sideways since early 2009 but a combination of increasingly-negative real interest rates and loose QE2 talk threatens to trigger a break of the bottom of the range and a second plunge lower. Departed MPC hawk Andrew Sentance frequently talks of his love of the music of the 1970s, including the 1973 Genesis album “Selling England by the Pound”. Are the doves nostalgic for a 1970s-style sterling crisis?



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