
IEA Shadow Monetary Policy Committee

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Institute of
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Shadow Monetary Policy Committee votes five / four to hold Bank Rate in February.

At its first face-to-face meeting in 2016, the Shadow Monetary Policy Committee (SMPC) voted to hold Bank Rate by a vote of five to four in February. A volatile start to the year framed the backdrop to the meeting, with financial market turbulence and oil prices at a 20-year low.

The closeness of the vote shows that the decision to hold rates is finely balanced. In addition, there is a majority on the committee with a bias to tighten. But the majority think that with the economy slowing, global financial-market turbulence continuing and the persistence of low price inflation, there was, on balance, a need to maintain low rates, for now.

Those wanting higher rates made the point that there is never a perfect time to raise them and that the longer the delay the higher the threshold for raising rates is in future. Indeed, they worry that if rates are not raised soon, the next downturn could strike and then cutting them will do little to alleviate its impact. Meantime, low rates are distorting markets and economic decision-making. Time to act, they argue.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997, with a briefer e-mail poll being released in the intermediate months when the minutes of the quarterly gathering are not available. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. To ensure that nine votes are cast each month, it carries a pool of 'spare' members. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a result, the nine independent and named analyses should be regarded as more significant than the exact overall vote. The next two SMPC polls will be released on the Sundays of 13th March and 10th April 2016, respectively.

Minutes of the meeting of 12 January 2016

Attendance: Philip Booth (IEA observer), Roger Bootle, Tim Congdon, Graeme Leach, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David B Smith, Akos Valentinyi, Peter Warburton, Trevor Williams (Chairman).

Apologies: Anthony J Evans, Jamie Dannhauser, John Greenwood, and Mike Wickens.

Chairman's comments:

Trevor Williams welcomed the committee to the first physical meeting of the New Year and invited Tim Congdon to present the monetary situation.

Global Money Round-up at the start of 2016

Tim Congdon referred to two papers and the prepared slides for the meeting, and provided a contextual background to the 2008-9 great recession. He said that it began with the banks, the freeze in the money market, and the failure of the Bank of England to provide timely liquidity, ending in the collapse in the growth of bank risk assets. The result was the sharp contraction in the rate of broad money growth and, with it, the rate of growth of nominal GDP.

The link between broad money and growth survived the 'Great Recession'

The regulatory onslaught on the global banking system and the squeeze on bank credit to meet stringent capital requirements meant that positive broad money growth was only possible because of QE. Statistics for the USA, Euroland, Japan and the UK showed that the relationship between broad money growth and nominal GDP growth had survived the period of the great recession.

Further rises in the Fed funds rate uncertain

Examining recent USA data in detail made it clear that there has been a resurgence in bank lending after a period of severe reduction in bank risk assets. However, in the last year while bank credit has grown at about 7% annualised, wholly justifying the rise in Fed rates, the figures for bank cash reserves suggest that a quiet reversal of QE has been going on, and that muddies the picture for the growth of broad money. M3 growth fell from an annual rate of 5.5% in November to 4.5% in December 2015. It is therefore unclear whether the Fed will continue with further rises in the Fed funds rate in the near future.

Optimism about the Eurozone

In the Eurozone, deleveraging of the banks has continued but there has also been the European Central Bank's QE programme that has seen a pick-up in the rate of growth of broad money. The economy has been better than at any time since 2007 with broad money growth now

growing at a healthier rate. While tighter bank regulation is a threat to moderate money growth, there is cause for optimism about the Eurozone economy with the expectation of above trend rate growth.

China to grow at trend rate

In the case of China, the figures show that the splurge in bank credit growth in 2009 that resulted in asset price inflation and goods inflation in the 2 years following has in turn resulted in contractionary pressure on monetary policy. Compliance with Basle rules and attacks on the shadow banks have created deflationary pressure. But QE with Chinese characteristics means that stock market turbulence has seen the PBOC effectively fund equity purchases to shore up stock prices. A rise in the inflation target and a cut in the prime lending rate is signalling a further easing of money.

India remains in good shape but Japanese monetary growth is still weak

India is basically acceptable. Broad money has come down to about 10%, which is about right. Japan is interesting where QQE (Quantitative and Qualitative Easing) has focussed on base money growth. In April 2014, they had another bout of QQE through an increase in the Base but broad money growth has remained low as bank lending has remained unresponsive to the excess cash reserves created by QQE.

Recovery in UK broad money growth

With the UK, there has been a recovery in the annualised growth rate of broad money, which recorded about 6% in the three months to November. Some of this is due to new lending by the banks. There is a worry about the effect of regulation and there is a concern whether this will continue. He said that although he had voted for a rise on one occasion he is not at all persuaded that bank balance sheets are set to grow rapidly and therefore does not see a need for a rise in the Bank Rate at the moment.

Discussion

Trevor Williams called the meeting to order, thanked Tim for the excellent presentation, and invited Patrick Minford to make his comments, as he had to leave the meeting early.

Danger of politicisation of QE policy with pressure to cancel the Bank's QE assets removing any chance of reversal

Patrick Minford said that he agreed with Tim Congdon's diagnosis of the crisis and the effect of bank regulation to deepen it. Central banks have mismanaged the crisis and have tried to blame banks for it. The question is what do we do now? Broad money is growing and because of substitution between monetary assets there has been growth in other areas such as peer-to-peer lending. The economy is therefore entering a different phase. However, what is worrying is the distortions created by QE, and now is the time to address these with a rise in rates. If the Fed continues to raise rates that will put pressure on the Bank to follow suit. The real worry is that if rates do not rise, pressure will be put on the Bank to liquidate QE and to cancel the Bank's holding of government debt thereby removing any chance of reversing QE. Furthermore, the Chancellor loves low interest rates as it allows him to fund government debt cheaply. He said that a move to negative rates like the Bank of Switzerland is highly undesirable. The economy is in the beginnings of a recovery with parallel markets ensuring a growing flow of credit. Therefore, he said that a move to normality is appropriate.

Falling oil prices is redistribution from producers to consumers

Roger Bootle said that he wanted to comment on a growing sense of pessimism as reflected in the recent predictions from the Royal Bank of Scotland (RBS). First, measures used by commentators to make negative predictions about China are imprecise. China is likely to grow at roughly its potential, which is about 3% to 5%. Second, most commentators were at one time worried about oil prices rising. Now they are worried about falling oil prices. What is really going on is a redistribution from producers to consumers. Falling oil prices has been very helpful to consumers, particularly in the Eurozone. Eastern Europe is growing well and the world economy is proceeding not too badly.

A slowdown but not a major downturn

Andrew Lilico said that regarding the growing commentary of pessimism from various circles like the World Bank, Larry Summers, and RBS, he agreed with Roger Bootle that things may be slowing but this is not a major downturn where we have to sell everything as recent research from the RBS suggests.

Low oil prices may raise the equilibrium real rate of interest

Philip Booth said that from a micro perspective a fall in oil prices may affect US banks through its loans to the oil industries and also falling oil prices may reduce the savings of oil producing countries that could result in a rise in the equilibrium real rate of interest. Also, China has moved to being a middle-income nation whose trend growth has fallen to 3% to 4% and so that is not a disaster. When governments meddle in stock markets the result is volatility and crashes.

China not in middle income trap

Akos Valentinyi said that he agreed with Roger Bootle regarding the slowdown in China. In any conventional growth model, we can expect, as the economy grows, convergence occurs and China approaches a middle-income state and that he saw no evidence of China being in a middle-income trap.

World economy reached escape velocity

Graeme Leach said that the world economy has reached escape velocity and it has been forgotten that one of the original purposes of QE is to bring broad money growth to 6%, which is where it is. While pressures exist on the banking system, the drivers of the global economy are positive. The domestic economy is at the turning point but there is no immediate need to change rates.

External risk factors

Graeme added that, regarding risk factors, the general feeling is that the world economy was moving along and broad money is rising well. UK recovery is doing ok. There was a discussion of external risks from a generalised middle-East war and the implications of increased immigration and the demographic and gender balance in Europe.

Strong UK import growth

David B Smith said that he wanted to comment about the UK economy. He said that trend growth in the UK on a ten-year view is close to 1.5% and that the size of import growth is an indication of a supply constraint where domestic demand is running ahead of aggregate supply.

FPC to control credit growth by intervention

Roger Bootle said that the role of the Financial Policy Committee on the micro management of credit markets suggests that the Bank is likely to be easy on interest rate rises and use the controls on credit, as with buy to let, to deal with government policy of home ownership. David B Smith said that this is like a return to the financial repression of the 1960s and 1970s, which had been a total failure then and would be again. Peter Warburton added that, while we recognise the low risk appetite of banks, the corporate sector is also affected by the same attitude and is voluntarily holding cash rather than investing.

Regulations are creating distortions

Before leaving Philip Booth said that since there was unanimous agreement within the committee about the distortions caused by regulatory intervention, the SMPC should voice an opinion in their recommendations. Trevor Williams agreed to add this point to the policy statement.

Votes

Trevor Williams called for votes and since there was more than the maximum number of members present for a vote, the last person to arrive, who was Peter Warburton, will have his vote discounted but that the Minutes will record his view.

Vote by Roger Bootle

(Capital Economics Ltd)

Vote: Hold Bank Rate.

Bias: To tighten.

Closer to changing vote

Roger Bootle said that he would rather wait and see how the recovery gathers pace and that the signs are good for the world and UK economy. He was close to the point when interest rates may have to rise but it was not there yet.

Vote by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate.

Bias: No bias.

Wait on more data

Tim Congdon said that he was for no change in Bank Rate and that his bias was in the middle between no change and a slight rise, which means that he wanted to see how the data pans out.

Vote by Graeme Leach

(Legatum Institute)

Vote: Hold Bank Rate.

Bias: To tighten.

No change but bias is shifting

Graeme Leach said that he remained a no changer. Quoting Hyman Minsky, he said that he believed that there were distortions in the market that could create instability from stability. A long period of low interest rates can create asset price distortions to bubble under the surface but he remained on balance a no changer with a bias to tighten.

Vote by Andrew Lilico

(Europe Economics)

Vote: Hold Bank Rate.

Bias: Imminent rise in rates.

UK growth solid and return on capital is rising...

Andrew Lilico said that he wanted a hold in rates now but with a bias to raise it by even next month. He said that he wanted to see-off the New Year funk of the financial markets before raising rates. He said that money supply growth is satisfactory and underlying growth in the UK is also acceptable. The world economy is not spectacular but recovering. The base effects of oil prices on inflation are on the point of dropping out. Rates of return on capital are now looking good and rising and interest rates should begin to reflect that.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate $\frac{1}{4}\%$.

Bias: To raise in small steps.

Expectations that interest rates will remain low for the medium term have to be challenged

Kent Matthews said that he had reversed his long standing call for a small rate rise at the last physical meeting because it coincided with negative inflation and he felt that the argument for a rate rise in that environment would be unconvincing. He said, however, that with hindsight this was a mistake as his arguments for raising Bank rate in the past were largely microeconomic rather than macroeconomic and nothing fundamental has changed to alter that position. He also said that while he had no direct evidence, his research on the funding of SMEs is suggestive that the supply side may be affected by the credit constraints that arise from financial repression and low rates. He said that he was concerned by a growing attitude in the financial markets of an environment of low interest rates and low inflation for the medium term. He recognised that there may be short term pain in a rise and therefore interest rate rises should be small and in small steps. But the message had to be sent that near zero interest rates were abnormal. He voted to raise rates in small steps starting with a $\frac{1}{4}\%$ rise.

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate ¼% and modest reversal of QE.

Bias: To raise.

Call has not changed

Patrick Minford said that he had not altered his position from past votes. He said that there is a need to return to normality through small increases. He said that he did not think small rises in the bank rate would jeopardise the recovery.

Vote by David B Smith

(Beacon Economic Forecasting)

Vote: Raise Bank Rate one-eighth per cent.

Bias: To raise in small steps.

For political reasons the government has failed to tackle the supply side

David B Smith said that he advocated a one-eighth rise in Bank Rate, primarily as a psychological signal to younger speculative borrowers that they cannot assume safely that borrowing costs would remain low indefinitely. Current monetary conditions were satisfactory and appropriate with real broad money balances growing at around 4% to 4½% and the real interest rate paid on broad money at around ½%. He said that one question is what will happen to both real magnitudes next year when inflation starts to rise? The supply side had been badly damaged by the Gordon Brown regime. However, the current government had exacerbated the UK's chronic supply-side inadequacies by failing to adequately address the government deficit/debt problem and had made things worse with Osborne's Bourbon-monarch style meddling with the tax structure and labour market. He said that we are in danger of going back to an Atlee-era regime where bureaucrats – including the financial regulators – think they always know what is best for society. Such creeping bureaucratic triumphalism would eventually kill any prospect of a dynamic British economy that could pay its own way in the world.

Vote by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate $\frac{1}{4}\%$.

Bias: To raise.

Output gap has closed

Akos Valentinyi said that with very low inflation driven by low oil prices, the economy is growing at a healthy rate. The output gap is closed. On the monetary side, growth of broad money of 4% to 5% is a good sign. The distortions from a low interest rate regime can be removed in this benign environment.

Vote by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate $\frac{1}{4}\%$; diversify existing QE into non-gilt assets. (Vote discounted).

Bias: To raise Bank Rate.

Switching QE assets to include commercial bank assets provides banks with risk capital to lend.

Peter Warburton said that he had been consistently asking for a rate rise since early 2013. He considers that there is little risk that raising Bank Rate from 0.5% to 1.5% over the next 12 months would damage demand. The more urgent issue is to release the banking sector from overbearing regulatory intervention. He said that the Bank should divert about £50bn of the existing stock of QE to purchases of assets on commercial bank balance sheets in order to release the banks from their regulatory capital constraints and free up lending capacity to the private sector. He agreed with Tim Congdon that the Bank of England should stop paying interest on bank reserves as a means of reducing excess reserves.

Vote by Trevor Williams

(University of Derby)

Vote: Hold.

Bias: Neutral.

Interest rate can remain low into 2017

Trevor Williams said that the economy is growing close to trend. Global risks are still high from commodity price shocks, and the slowdown in China. He does not believe that rates will rise in the near future and will remain low into 2017, which is also supported by some models that show that, in current conditions, as output grows at trend, real rates will remain low and stable.

Policy response

1. On a vote of five to four the committee agreed to hold the Base rate at its current level. The narrowness of the vote as in the past shows the fineness of the committee's balance of thinking on the direction of policy. On the basis of overall attendance, the vote for a small rise against a hold was 50-50.
2. Three members voted to raise Base rate by $\frac{1}{4}\%$ and one member voted to raise Bank rate by one-eighth of a per cent.
3. There was a growing feeling among the majority of members that rates will rise in the near future.
4. There was unanimous agreement that regulatory intervention had distorted the market and hindered the recovery. The correct policy response should be to at least start to reverse this bias.

Date of next meeting

Tuesday, 12th April 2016

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 IEA and the *Sunday Times* newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is Trevor Williams (University of Derby). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Graeme Leach (Legatum institute), Andrew Lilico (Europe Economics and IEA), Patrick Minford (Cardiff Business School, Cardiff University), David B Smith (Beacon Economic Forecasting), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd) and Mike Wickens (University of York). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.



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