IEA Shadow Monetary Policy Committee

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Institute of Economic Affairs

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Shadow Monetary Policy Committee votes Seven / Two to Hold Bank Rate in September.

In its September 2016 e-mail poll, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of Eight to One, to hold rates in September. The dissenting votes were for immediate rises in rates — in one case to 1% and in the other to 0.75%.

Those voting were united in their criticism of the Bank of England for being premature in its interest rate cut and additional Quantitative Easing (QE) announcement in August. A number of members noted that that decision looks particularly suspect in the light of the very strong monetary growth figures in the three months to July.

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 SMPC poll will be released on Sunday 30th October 2016.

Votes

Vote by Philip Booth

(St. Mary's University, Twickenham)
Vote: Raise Bank Rate to 1%.
Bias: Neutral.

It is clear from the deliberations of the Bank of England's last meeting that they are (a) changing their mandate from the one given to them by parliament (as they believe that inflation will overshoot but are still loosening monetary policy) and (b) assuming to monetary policy a role that it cannot play - that is to correct for real shocks to the economy (though if they had an NGDP target, things might be different). That is to say nothing of whether the real shocks they seem to have in mind will actually turn out to be negative shocks.

It is, of course, the right of the governor or any member of the MPC to comment on the mandate if they think it is inappropriate. Nevertheless, they should act in accordance with it. If the MPC do not agree with the mandate they are given they should either abide by it obediently (show assent of the will and intellect as theologians might say in relation to the majisterium of the Catholic Church) or resign. I would expect the governor of the Bank of England to take the lead in this respect.

Vote by Tim Congdon

(University of Buckingham)
Vote: Hold Bank Rate.
Bias: Raise.

As ever, I am in favour of stable growth of the quantity of money, broadly-defined, at a low, non-inflationary rate. It is clear that in the three months to July the M4x aggregate was rising much too rapidly. The Bank of England should stop its current round of QE asset purchases. For the moment I am in favour of no change in interest rates, but the data need to be watched. If money growth runs consistently above 5% at an annualised rate without QE, interest rates should be raised.

Vote by Jamie Dannhauser

(Ruffer LLP)
Vote: Hold Bank Rate.
Bias: No bias.
One-year view: Gradual rises in rates.

At its August meeting, the MPC voted for a package of easing measures, aimed at softening the blow post-referendum. This included: a 25bps cut in Bank Rate; an expansion of the Bank's quantitative easing programme; and a new facility, the 'Term Funding Scheme', to subsidise UK banks' access to wholesale funding. In addition, and in concert with the MPC's actions, the Financial Policy Committee (FPC) decided to loosen some of the regulatory constraints facing the banking system, with the aim of bolstering banks' credit supply in the face of a weakening macroeconomic backdrop.

The case for pre-emptive monetary easing was not robust. Since the referendum, most (if not all) Shadow MPC members have been uncomfortable with the language and actions of the MPC. Ex-post, the MPC's judgements may prove to have been reasonable; but it is far from clear, even now, how the UK economy will respond to the vote to the leave the EU. The MPC appears to have placed considerable weight on the purported empirical links between 'uncertainty shocks' and subsequent output growth. This body of work suggests that a shock of the size and nature of the Brexit vote should have immediate, meaningful and lasting effects on economic activity. In its latest forecasts, the MPC expects flat output through H2 and only a sluggish recovery thereafter. Indeed, the downward revisions to the MPC's growth forecasts (since the May Inflation Report) are the largest since the committee was first formed.

That the UK economy will slow after the June 23rd vote is not in dispute. There is widespread anecdotal evidence, and some hard data, that spending on big ticket items – property transactions, business capex etc. – has been delayed. However, the magnitude and persistence of the economic slowdown is at this stage almost impossible to gauge. Moreover, it is even more difficult to assess whether this 'shock' should be viewed as an 'uncertainty/demand' shock or a lasting hit to Britain's 'supply capacity'. Somewhat puzzlingly, this was clearly acknowledged in advance of the referendum by the MPC, with the minutes of the June meeting making clear that the direction of policy in the event of a 'Leave' vote was ex-ante not obvious.

What we do know, however, is that the inflation outlook over the next 12-24 months has changed markedly because of the large currency depreciation. In part because of the expectation (and subsequent realisation) of additional monetary stimulus, the Pound is down sharply from its pre-referendum level. Indeed, the trade-weighted value of Sterling is down by 15% or so since the start of the year. While there is little academic agreement on the full extent of pass-through to consumer prices, the literature is clear that an exchange rate shock of this nature will have a sizeable and lasting impact on CPI inflation. Recent work by a current external MPC member, Kristin Forbes, makes this point forcefully (http://www.bankofengland.co.uk/publications/Pages/speeches/2015/839.aspx).

Going forward, monetary policy has to balance two opposing forces: the downward pressure on inflation from weaker demand growth (the 'uncertainty shock'); and the upward pressure on pricing from the fall in Sterling, and the related damage to the economy's supply capacity (the 'exchange rate' and 'aggregate supply' shocks respectively). There is simply insufficient hard data, anecdotal evidence or business surveys to assess where the economy is post-referendum, let alone which of these shocks will dominate in coming months.

But policy also has to be acknowledged that the economy was on a solid footing pre-referendum. In contrast to the situation in 2010/11, when headline inflation last spiked, or indeed to the situation after Britain left the ERM in 1992, the economy was close to full employment at the end of Q2. Surveys of spare capacity within firms suggest capacity utilisation was a little above normal; indicators of labour force utilisation point to little or no slack in the jobs market, with some even suggestive of material recruitment difficulties. Moreover, monetary indicators (we have complete data through July) argue strongly against any easing of monetary policy at this point. Bank lending growth (as measured by M4Lex) is still accelerating, while broad money growth (using the MPC's preferred M4ex measure) remains at a level consistent with a solid expansion of nominal demand.

It will not be until late autumn/early winter that we get a clearer picture of the economic aftershock of the June 23rd vote. Until that time, monetary policy should be on hold. The evidence available to date confirms an economic slowdown but one that is fairly limited so far, especially in the context of the MPC's own growth projections. Indicators of consumer demand remain buoyant, although consumer confidence has weakened. Business sentiment fell sharply after the vote but has since bounced back somewhat. The widely-watched PMI surveys, for instance, point to a pick-up in activity in August, after a slump in July, with the composite activity index (a weighted average of manufacturing, service and construction indices) actually at a five-month high.

But the most appropriate reason for a 'wait-and-see' approach to monetary policy is that we have little idea how fiscal policy will respond. The Osborne plan has been ditched; but as yet we do not know whether this simply means a slower pace of budget consolidation; or in fact an overt fiscal expansion in the short-term, something that both the new Prime Minister and Chancellor have hinted at. Since we are likely on the verge of a material shift in Britain's fiscal strategy, and given the massive uncertainty about the economic damage from the referendum vote, it is inappropriate for monetary policy to have responded aggressively and pre-emptively. It is doubly inappropriate for the MPC to have signalled additional easing over the autumn.

Vote by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate; Hold QE.
Bias: Bias to increase interest rates; no bias for QE.

UK broad money supply M4ex rose by 6.9% (y-y) in July, up from 6.0% (y-y) growth in June. Just as the Bank of England throws the proverbial kitchen sink at the 'stuttering' UK economy, broad money is growing at its fastest rate since the recovery began. Between April and July this year M4ex growth has accelerated from 4.1% (y-y) to 6.9% (y-y). The three-month annualised rate of growth in M4ex exploded to 14.7% in July.

The most recent money supply figures are also striking for the sectoral differences in money holdings, between households, private non-financial corporations and the financial sector (NIOFC non-intermediate other financial corporations). Household broad money growth was up 6.7% (y-y), PNFC broad money growth was up 6.1% (yr-on-yr) and financial sector broad money growth was up 9.3% (y-y) in July.

Even if we focus on non-financial M4ex alone, on the basis that the link between money and spending is likely to be stronger for households and companies, than for the financial sector, there's nothing in the broad money statistics to indicate the UK is heading for a recession. Quite the opposite, especially with headline inflation of just 0.6% (y-y), suggesting most of the nominal growth could translate into real growth. The money supply numbers provide a strong signal that the economic doom and gloom post Brexit has been way overdone.

If we look at divisia measures of the money supply (weighted for transactions purposes), these also show robust growth. Household divisia money was up 10% (y-y) in July, whilst PNFC divisia money was up 11.3% (y-y).

We should also be hesitant about focusing on non-financial M4ex to the exclusion of financial sector M4ex. The transmission mechanism from money to spending may be more direct for households and PNFCs, but this doesn't mean there's no transmission mechanism for the financial sector. The transmission mechanism is more complicated, but so too is the mechanism for QE, and we don't dismiss that.

Regardless of this, however, the monetary statistics show 2 things. Firstly, they provide reassurance about the risk of recession. Secondly, they might even provide tentative evidence that the economy could be strengthening, not weakening. There's little or nothing in wider economic statistics to challenge this view either. Virtually all the data over the past 2 months showing either: (1) A strong head of steam in Q2 prior to the referendum, or (2) A bounce-back in the latest figures. Associated with this, of course, is the depreciation in sterling post Brexit. This all suggests that if the rate of broad money growth accelerates any further, there will be a strong case for tightening not easing monetary policy. We're not there yet, but August's broad money supply numbers will be important.

Vote by Andrew Lilico

(Europe Economics)
Vote: Hold Bank Rate.
Bias: to Raise.

In the three months to July 2016, M4ex broad money grew at an annualised rate of 14.7%. The previous peak for this series, which goes back only to 2009, was 8.7% in the three months to June 2016. We do, however, have quarterly data going back to 1998, which show that all all-time peak of 12.8% in 2006. Thus, broad money growth in the three months to July (half of which was in the period following the EU referendum) was the highest recorded three-monthly rate available in the data going back to 1998, higher even than the peaks of the mid-2000s when monetary growth is now widely recognised as having been allowed to get out of control.

It is true that the Bank of England has come to prefer the M4ex series over its previous traditional M4 series because certain internal financial sectors in the M4 series are now regarded as having distorted the series. Perhaps subsequent analysis will suggest that these latest, extraordinary M4ex figures have been subject to some similar distortion. Another possibility is that rapid growth in the period just before and just after the EU referendum reflects a deliberate Bank of England policy of de facto loosening prudential and liquidity requirements, so as to pre-empt concerns about a financial crisis in the event of a vote to leave the EU. If that is indeed the main driver, it could prove relatively straightforward for the Bank to re-assert control of monetary growth by returning to enforcing its regulatory standards.

However, as matters stand, such rapid monetary growth makes the Bank of England's decision to cut rates and do additional QE in August appear absurd and possibly even dangerous. Cutting rates in the face of such a huge rise in monetary growth, when there are such large volumes of QE in the system with relatively untested implications for stimulating sudden surges in broad money growth, should have required some remarkable emergency rationale. But, even if subsequent analysis suggests that the M4ex growth is a statistical artefact or a one-off event, there would still have been no emergency rationale for a rate cut.

The Bank appears to have been influenced by some combination of strong assumptions about the negative short-term impacts of the vote to leave the EU and some weak PMI data in the early part of July. But the MPC's own analysis of the short-term impacts of a Leave vote suggested that it was ambiguous whether it would be more negative for supply (implying a need to raise rates) or more negative for demand (implying a need to delay rate rises or enact further loosening, of some form). And to cut rates on the basis of about two weeks of weak PMI data, in a period when firms were still emotionally adjusting to the Leave vote in an environment when all official forecasts were telling them there would be a hugely negative impact for the economy, was surely unjustifiable.

The PMI data has snapped backed in August. GDP growth in the third quarter will probably still be fairly weak — indeed, it would be astonishing were that not so, in the light of such a significant change in the planning outlook as is implied by leaving the EU. Those that had interpreted the July data as demonstrating that the economy was either already in recession or about to enter it now say it is premature to claim that the August data demonstrate that there will be no negative short-term impact of leaving the EU. They are right now and they were wrong then.

The Bank should avoid reinforcing the sense that its decision-making is blown around randomly by events by reversing its August interest rate error immediately. But it should definitely cease any further QE purchases. And if the Q3 growth data show only a modest dip in growth, rates should be rising by November.

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Hold Bank Rate.
Bias: to Raise.

Astonishingly the July 2016 Consensus forecast growth rate for the UK in 2017 was 0.6%, close to a recession. Forecasters generally followed the UK Treasury's lead in projecting a 'doom and gloom' scenario after Brexit. Of course now that we have had the strong July figures for retail sales, the continuing strength in employment into August and the latest PMI for manufacturing (53.3), construction (49.2) and Services (52.9), with 50 being the cut-off for positive growth in these indices, we will no doubt see these forecasts being raised and we expect this raising to continue.

Here is a short summary of recent hard data which totally contradicts that Consensus forecast:

- GDP growth: 0.6% Q2. Our projection for Q3: 0.6%.
- Purchasing Managers Indices August(Markit/CIPS): Manufacturing 53.3; Construction, 49.2; Services, 52.9
- Retail sales volume July: 5.9% up year-on-year (yoy); 1.4% up on June. 3 months to July, 5.2% up yoy; 1.8% up on previous 3 months (7.4% annualised).
- Employment: current (April-June) employment rate 74.5%, up 1.1% yoy. Unemployment rate, 4.9% August (down 0.7% yoy). Unemployed claimants in July: 763.6 thousand (2.3%), down 8.6 th from June and 27th (0.1%) yoy.
- Money and credit: Broad Money/Lending (M4ex) growth July 6.9% yoy (annualised 3-month rate 14.7%).
  - Divisia Money growth July, yoy: households 10%, PNFC 11.3%
  - Net credit card lending July, £291 million, 20% up yoy
- House prices, August: 0.6% up on July, 5.6% up yoy (v 5.2% in July).

Given these latest developments I expect growth to continue at current rates of 2-3% per annum, much as we forecast back in early May. I also expect consumer spending to remain strong and private investment to continue growing moderately as in Q2. Net exports will rise on the back of the fall in sterling and inflation will rise quite sharply, with it also wage rises because of the continuing rise in employment and the tight labour market, pushed ahead too by the rising minimum wage and the new controls on unskilled immigration. Public spending will move towards less restraint especially on infrastructure; but in spite of this the public finances will improve with rising tax revenues and the debt-GDP ratio will start to fall within the next year. Rising inflation will soon be seen as a threat to the inflation target by the Bank of England and interest rates will have to be raised.

It is already clear as Tim Congdon points out that monetary growth is accelerating. The decision of the Bank to cut rates and restart QE now looks as if it was a mistake.

To reverse it now would be premature. But my view would be that we should look for the earliest opportunity to do so. Looking further ahead as pointed out above the need will be to raise rates steadily for some time as inflation increases.

Vote by Akos

(University of Cardiff)
Vote: Raise by 0.5%.
Bias: No bias.

Vote by Peter Warburton

(Economic Perspectives Ltd)
Vote: Hold Bank Rate.
Bias: to Raise.

The Treasury's expectations of the likely immediate impact of a Brexit vote on UK economic activity, readily endorsed by the Bank of England, look to be wide of the mark. First and foremost, the referendum result did not register as a global financial shock. While the depreciation of Sterling that greeted Brexit has been largely sustained, the initial sharp fall in the UK stock market has been overtaken by a more impressive rally. UK government bond prices, which might have tanked in anticipation of a jump in the inflation rate, have followed instead the global trend to extraordinary peaks.

The explanation of this wide divergence of outturns against official (Treasury and Bank of England) expectations lies in two different views of the impact of uncertainty. When academics incorporate heightened uncertainty into their analytical economic models, they tend to predict an immediate drop in activity. The models assume that everyone shares a negative opinion of the eventual impact of Brexit and adjusts their output to this lower level as soon as possible. In real life, folks are more adaptive in their behaviour, gradually adjusting to the possibly lower trajectory for economic growth over a number of years.

When government and central bank officials looked at the first round of PMI survey data pertaining to July – a well-known survey of purchasing managers – their worst fears seemed to be confirmed. There was a plunge in the index. By construction, diffusion indexes such as the PMI don't differentiate by degrees: if all those surveyed think that business conditions will get slightly worse, then it will register a weaker reading than if 90% of people believe that business conditions will get a lot worse and 10% vote unchanged. Now that more solid data is starting to become available, it seems that this inherent weakness in diffusion indexes may be responsible for an unduly negative PMI reading for July. For example, the timeliest data from the Office of National Statistics (ONS), such as the Retail Sales Index, show robust sales volumes. Moreover, the August PMI, released this week, has had a strong positive rebound.

Aside from the PMIs, there has also been a barrage of negative consumer confidence surveys. The well-respected GfK consumer confidence survey suffered its biggest fall in 26 years after the Brexit vote. However, in the subsequent month this measure jumped 5 points, suggesting that the fall in confidence was spurious. The UK economy has been underscored by robust consumer spending.

Another source of timely data is the housing market. Despite expectations that Brexit would be bad for housing activity and prices, this has not been borne out in the data. The transactions and price data show a more positive picture than the surveys. The most recent house price data from Nationwide suggests that average national house prices rose 0.6% between July and August. Housebuilders' share prices have regained a substantial portion of their initial Brexit-related losses.

In summary, the economic costs of Brexit, be they large, small or absent, will be spread out over many years. This prospect is far into the future, and much too uncertain to become embedded in economic behaviour today. The Bank of England acted hastily at its August meeting, addressing an imaginary V-shaped slump. Credit and monetary indicators were on a recovery trajectory before June and growth rates have not fallen away. Given the accumulation of evidence that the economy has sustained its momentum since 23 June – and may even have strengthened due to deferral of business spending prior to the vote – then the Bank should look to reverse the 25 basis point cut before the end of the year.

Vote by Mike Wickens

(University of York)
Vote: Hold Bank Rate.
Bias: Neutral.

The recent cut in interest rates and additional QE was unnecessary and was a misreading of the state of the economy after the referendum. But as monetary policy should not contribute to economic volatility, these errors should not be corrected immediately. As was to be expected, the exchange rate had already weakened and so did not need further weakening. And the economy showed little sign of slowing. The most monetary policy should have done was to have remained passive and be ready to combat future expected inflation arising from the fall in the exchange rate. Instead it added to its distortion of the economy, pensions and asset markets. Will the MPC have the courage to admit the errors in their group-think and base monetary policy on economic fundamentals?

Policy response

1. On a vote of seven to two, the Committee voted to hold Bank Rate.

2. One members voted for an increase of 0.5% and another an increase of 0.75%.

Date of next poll

Sunday, 30th October 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 (Derby University). 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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