IEA Shadow Monetary Policy Committee

November 2016

Institute of Economic Affairs

For further information please contact:

Andrew Lilico	+44 (0) 20 7269 2644	andrew.lilico@europe-economics.com
Philip Booth	+44 (0) 20 7799 8912	pbooth@iea.org.uk
Richard Wellings	+44 (0) 20 7799 8919	rwellings@iea.org.uk

Embargo: Not for publication before 00:01am Sunday 30st October.

Shadow Monetary Policy Committee votes five / four to raise Bank Rate in November.

At its October 2016 face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of five to four, to raise rates in November. Of the five members favouring a raise, three preferred a rise of 0.25% and two a rise of 0.5% Of the four members voting to hold, three had a bias to raise rates soon.

All those members expressing an opinion felt that the August rate cut by the Bank of England had been a mistake. However, a number of those feeling this way felt constrained, by that error, from voting to raise rates at this stage because of the credibility damage that might cause to the Bank. Others felt that the fundamentals should dominate the decision. Monetary growth is very strong, GDP growth is solid, inflation is forecast to go far above target, and the pound is weak, providing a very considerable monetary boost and driving inflation above target over the planning horizon. These factors, they felt, were sufficient to justify a rise which past errors should not prevent. No member felt there was any evidence Brexit has had a negative impact of a scale that necessitates or justifies ongoing monetary loosening.

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 Sunday of 10th December 2016.

Minutes of the meeting of 18 October 2016

Attendance: Philip Booth, Jamie Dannhauser, Graeme Leach, Andrew Lilico (Chairman).

Apologies: Roger Bootle, Anthony J Evans, John Greenwood, Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Mike Wickens and Trevor Williams.

Chairman's comments

Andrew Lilico announced certain minor administrative points, then invited Graeme Leach to present the monetary situation.

Monetary background

[Note that The SMPC meeting was held on the 18th October, before the release of 3rd quarter GDP figures on the 27th October. However, where relevant, reference is made to the 3rd quarter GDP figures. The release of the provisional third quarter GDP figures on 27th October showed a quarterly rise of 0.5% and an annual rise of 2.3%. This compared with a quarterly rise of 0.7% and an annual rise of 2.0% in the second quarter. Perhaps more significantly the service sector expanded by 0.8% in the third quarter, whilst the manufacturing and construction sectors contracted.]

With regard to the UK economy, Leach argued that there is an assumption that economic uncertainty will undermine economic growth, but as yet there is very little evidence of it actually doing so – you can see Brexit everywhere but in the statistics.

Leach argued that "if Godot is a sharp economic slowdown, then Godot is unlikely to arrive". Indeed, the opposite, a pick-up in economic growth, might occur. This seemingly counterintuitive view was based on the potential stimulus from faster broad money supply growth and the depreciation in the pound, offsetting the potential impact of uncertainty on business investment. At the time of the SMPC meeting, the pound is touching a 31-year low against the dollar, with sterling down 18%. Of course, the key uncertainty is uncertainty, which is extremely difficult to model for forecasting purposes.

Much of the discussion centred on how the recent acceleration in broad money growth M4x would play out in stronger nominal GDP growth. Annual M4ex growth accelerated from 4.1% in April to 4.9% in May and 6% in June. It has since accelerated further to 7.3% in August.

The debate centred around the growth in household, PNFC and financial sector money. The three-month annualised rate of M4X growth was very strong in July and August, at 14.7% and 10.9% respectively. Rates of growth this strong are unlikely to be accompanied by an economic slowdown, unless they led to a significant tightening in monetary policy.

Just as the MPC was “throwing the proverbial kitchen sink” at the economy, Leach argued that broad money growth was the fastest since the introduction of QE, and that just as everybody believed the economy was contracting, in actual fact it was probably expanding. Indeed, Leach expressed the view that with annual monetary growth reaching 6% and with solid GDP growth, the UK economy had finally reached “escape velocity” in June-July, making the Bank of England’s August rate cut especially counter-productive.

The discussion widened to consider the strong post-Brexit performance of other economic indicators, such as the ONS Index of Services, which covers almost 80% of GDP. The broad conclusion of this discussion was that economic indicators were showing a strong head of steam prior to the Brexit vote and/or they dropped sharply in the immediate aftermath of the vote, only to bounce back strongly thereafter.

HM Treasury short-term forecasts were criticized because they were based on 2 fallacies. Firstly, that Article 50 would be triggered immediately, and effectively this would increase uncertainty, not reduce it. Secondly, that the Bank of England would effectively do nothing in response to any weakness arising from Brexit.

With regard to developments in the world economy. Discussion on the US economy centred on the 40 year low in initial jobless claims and the fact that the natural rate of unemployment in the US was probably at or even below the natural rate. However, this was not necessarily the precursor to an inflation threat. The discussion centred around the ‘reservoir of potential workers’ due to a potential increase in the prime age participation rate after declining for many years.

With regard to China, the views expressed suggested that Chinese GDP growth was likely to be just under 7% this year, but there were conflicting signals from different economic indicators. For example electricity production suggested stronger growth than implied by outstanding yuan loan growth.

Japan remains beset by difficulties, with the recent Tankan showing manufacturing sentiment at its lowest since the onset of Abenomics. It was also noted that September saw a switch in emphasis by the Bank of Japan, from the money supply to maintaining 10 year Treasury yields close to zero. The Government also announced a 28 trillion yen stimulus package recently, but as the economic record shows, the actual stimulus from fiscal packages is almost never as big as announced, with new spending (freshwater) around a quarter of the headline figure. With regard to the third element of Abenomics, namely structural reform, the Bank of Japan estimates that the potential economic growth rate has barely improved since Abe came to office.

With regard to the euro-zone it was noted that the vital signs are very different now, than at the height of the euro-crisis. For example, Italian 10 year bonds are yielding only 1.4% at the time of writing. GDP growth in the euro-zone was expected to be around 1.5% this year and next. However, Leach argued that the worst of the euro crisis may not be behind us but in front in the longer term. Fears over Italian banks have receded, but with Italian nominal GDP around 20-25% below trend, a banking crisis is almost inevitable at some point over the coming years. Leach also highlighted that by 2020 the Italian economy could have experienced almost 2 decades of lost growth.

Moreover, the economic threat from demographics in the 2020s, could actually lead to 3 decades of lost growth. Such a scenario risked economic and political crisis.

The Chairman thanked Graeme for his presentation and opened the meeting to general discussion.

Discussion

Jamie Dannhauser reported the fruits of some deeper analysis he had conducted into the monetary data. His view was that rapid monetary growth had been significantly driven by fund managers maintaining high cash balances (only 9/11 had been associated with a similar level of cash balances). It was not totally clear what these balances were being used for. One possibility is that they were associated with derivatives in some way, perhaps being required for collateral. One possibility raised by a number of committee members was that their origin might be irrelevant, but they would instead feed through into broader monetary pressures. However, Jamie Dannhauser said that whilst that was one possibility, another was that their use for collateral might involve offsetting rises in monetary demand as well as monetary supply.

Andrew Lilico asked whether the Brexit vote had been having a noticeable impact on the UK and the Eurozone. Graeme Leach expressed the view that, with the positive impacts of the fall in the pound likely to dominated uncertainty impacts, Brexit could well turn out to be unambiguously positive for the economy in the short term as well as the longer term. He estimated that the fall in the value of the pound might be roughly equivalent, in terms of monetary stimulation, to a 1.5% cut in interest rates.

There was a consensus that a “soft Brexit” (understood to mean the UK staying in the European Economic Area) is very unlikely. Graeme Leach said he was adapting his analysis to an emerging assumption that the UK will simply leave the EU and adopt a stance of unilateral free trade. Other members felt this less likely.

As to the impacts of Brexit on the Eurozone, these were felt to be as yet unclear. Andrew Lilico raised the case that if the EU attempts to “punish the UK for leaving”, that could result in a loss of GDP for the EU, potentially re-igniting the Eurozone crisis.

There was a discussion as to whether the pound might yet depreciate further. Andrew Lilico noted that the pound is now widely regarded as under-valued even on “bad Brexit” scenarios in which there is a total breakdown in relations with the EU. Foreign currency movements are notoriously difficult to predict. Nonetheless, it was suggested that the pound is currently moving in response to “focal point trading” as market agents responded to the way they assumed other market agents would respond to speeches, leaks or other political indicators of emerging Brexit intentions. In due course, once the expectation that sterling might fall further is reduced, there could be a rise in cross-border M&A activity, leading the pound to strengthen.

One potential focal point trigger to shift attention away from the pound, allowing it to appreciate once again to a more sustainable level, was felt to be the US elections. Another idea explored was whether the pound might strengthen markedly in response to even very small Bank of England interest rate rises or even simply to the Bank of England ceasing to suggest it might yet loosen further. Jamie Dannhauser noted that the previous Inflation Report forecasts the highest overshoot in inflation, above target, at the planning horizon, since 1997, and that that was on an assumption of steady fiscal policy which will not be met — with surely further announcements of fiscal loosening to come in the Autumn Statement. And yet the Bank of England was in loosening mode!

It was noted that the Bank of England, before the referendum vote, suggested that Brexit might have a negative impact on potential supply as well as upon potential demand, meaning there is no clear reason lower GDP growth associated with Brexit should imply lower, rather than higher, rates in an inflation-targeting framework.

The Chairman invited the members of the Shadow Monetary Policy Committee to summarise their views and offer their votes.

Votes

Vote by Philip Booth

(St Mary's University, Twickenham)
Vote: Raise Bank Rate by 0.5%.
Bias: Neutral.

Philip Booth stated that the Bank of England has a mandate set by the government (even if some of the public pronouncements by MPC members suggest they believe they set their own mandate and politicians have no role). The level of sterling, M4ex growth and GDP suggest there is scope to tighten. So do so.

Vote by Jamie Dannhauser

(Ruffer LLP)
Vote: Hold.
Bias: to Raise.

Jamie Dannhauser said he believed the August rate cut was a mistake, but that it could be counter-productive to attempt to reverse it now. He felt M4ex and GDP growth were at a satisfactory level that necessitated neither tightening nor easing urgently. He was less sanguine than others about the potential for the depreciation in sterling to support economic growth next year. He feared that the benefits would be slow to arrive but the costs in terms of higher inflation and higher intermediate goods costs would be faster. He feared the inflation that would result might become embedded.

Vote by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate and stop QE.
Bias: to Raise.

Graeme Leach felt that the reasons for rapid M4ex growth were poorly understood and should be a concern. He felt the August rate cut was unnecessary. But he felt the Autumn Statement should be heard, to understand the general policy backdrop better, before raising.

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by 0.25%.
Bias: to Raise further.

Andrew Lilico felt that the August rate cut was a mistake which had contributed to the excessive fall in sterling and unnecessary inflation in 2017/18. He felt that a small rise in rates would produce a disproportionately positive impact on the value of the pound at this point, allowing the Bank of England to meet its inflation target.

Votes in absentia

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by 0.25%, end QE.
Bias: to Raise.

Vote by Roger Bootle

(Capital Economics)
Vote: Hold rates.
Bias: to Raise.

Vote by Akos Valentinyi

(University of Manchester)
Vote: Raise Bank Rate by 0.5%, no QE.
Bias: to Raise.

Vote by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by 0.25%; Reallocate £50bn of QE from gilts to infrastructure bonds.
Bias: to Raise Bank Rate in stages to 1.5%.

Another robust set of UK activity data (a preliminary estimate of 0.5% growth in Q3) has defied official expectations of an abrupt loss of economic momentum. Meanwhile, Sterling has been subjected to another battering on the forex markets as remarks at the Conservative party conference appeared to indicate that the only Brexit available was a 'hard' Brexit. Such a large cumulative fall, 18% on the Sterling Index, has given the Bank of England pause for thought on its planned further cut in interest rates. If true, then this reconsideration of monetary strategy is long overdue.

If lower interest rates impart stimulus to the UK economy, then the lower the rate, the greater the stimulus? If lower positive interest rates boost aggregate demand, then negative rates, the more so? Logically, the maximum stimulus is achieved at minus infinity. This is a clear example of reductio ad absurdum, a debating tactic which invariably lacks coherence.

What possible benefit could be expected to accrue as a consequence of the August cut in UK Bank Rate? Analytically, it is possible to assert that a lower discount rate will bring forward household consumption, that a lower cost of capital will boost fixed capital formation and that higher property and financial asset prices will inflate the net worth of households and businesses, inducing them to save less and spend more.

However, when interest rates are extremely, abnormally and persistently low, other possibilities must be considered. When interest rates fall out of bed, there is a risk of concussion. Concussion is difficult to incorporate in analytical models, but is no less of a reality.

The flip side of very low borrowing rates – note, for example, the 4.1% personal loan rate and the 2.3% lifetime tracker mortgage rate – is extraordinarily low saving rates – exemplified by instant access deposit rates (less than 5 basis points) and fixed rate bond deposits of 0.85%. There comes a point where borrowing rates are no longer a material obstacle to borrowers. They may fail to qualify for loans based on their disposable income, credit score, postcode or other criterion, but the rate is immaterial. Consumer debt is motoring along at 10% per annum and in no obvious need of assistance.

Older savers, on the other hand, are perplexed by the persistence of low rates. Fearing penury in their latter years, senior citizens are apt to save more of their non-interest income in order to top up their capital.

Banks typically suffer a squeeze of their net interest margins as interest rates approach zero, leading them, on occasions, to raise borrowing rates to restore profitability. The systematic compression of the government yield curve makes it harder for insurance companies to deliver promised returns to policyholders and threatens the solvency of the weaker companies.

Actuarial adjustments based on lowered bond yields have a profound effect on pension deficits. With 80% of company-sponsored funds in deficit, many businesses will be required to inject funds into their schemes at the expense of investment spending. Defined contribution pension will project lower retirement incomes.

There is a generalised cost to be borne by the financial system when liquidity is hoarded within financial institutions and large corporations, rather than pooled for the benefit of all. A zero interest rate equals a zero incentive to offer surplus liquidity into the market.

The wider impacts of falling returns in a complex, leveraged, financial system could easily overturn the expectation of a net economic stimulus when rates are abnormally low.

Business investment in structures, plant and equipment has been a serial disappointment to policymakers over the past 7 years and, if anything, the trends are worsening. Could it be that the capital spending decision has been soured by ultra-easy money and quantitative easing? Are decision makers unsettled by the fresh doubts cast by policy easing on the economic outlook? As policy uncertainty increases, perhaps the option value of cash rises to offset its lower return? Have large scale asset purchases crowded investors into the securities of cash-rich companies, persuading them to distribute income rather than commit to fixed investment. Bond yields may be lower, but has the hurdle rate for business capex risen?

There are ample grounds to suspect that the effectiveness of lower rates as a policy stimulus have been overtaken and overwhelmed by other considerations and behaviours. It is time for a re-think.

The normalisation of UK interest rates is long overdue. My preference is for an immediate Bank Rate rise of 0.25%, with a target of 1.5% for Bank Rate by mid-2017. I consider the additional £60bn of QE to be unnecessary, but would support a reallocation of £50bn of existing QE from gilts to infrastructure bonds, should the need arise for additional stimulus.

Vote by Trevor Williams

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

Whether the rate cut and aggressive policy response from the Bank of England have helped the economy perform better than consensus, and their own forecast, will never be known but the economy is holding up well thus far post-referendum.

On most current economic metrics, money supply, inflation expectations, and growth in GDP the rate cut was seemingly not warranted. Market reaction: weaker sterling, rising gilt yields and heighten inflation expectations also suggest overkill.

However to reverse now with Brexit negotiations not yet started could be to invite further market turmoil. Thus I vote for rates to remain on hold with a neutral bias, as the actual start of talks to leave, and the steady drop of news about them, could see a negative economic and market reaction.

Policy response

1. On a vote of five to four, the Committee voted to raise Bank Rate.
2. Three members voted for an increase of 0.25% and two of 0.5%.

Date of next minutes

Sunday, 10th December 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.

Institute of
Economic Affairs

Institute of Economic Affairs
2 Lord North Street
London
SW1P 3LB

www.iea.org.uk