IEA Shadow Monetary Policy Committee

March 2017

For further information please contact:

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

Embargo: Not for publication before 00:01am Sunday 12th March

Shadow Monetary Policy Committee votes Seven / Two to Raise Bank Rate in March.

In its March 2017 e-mail poll, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of Seven to Two, to raise rates in March. Three members voted for an immediate rise of 0.5%. Fourther favoured a 0.25% rise.

Advocates of raising rates noted that economic growth is steady, monetary growth has been strong, inflation is rising and set to go comfortably above target and sterling is fairly weak. This would appear to be a textbook situation for a rate rise.

Those advocating a hold felt it was worth waiting to see what happens next when Article 50 is triggereds.

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 7th May 2017.

Votes

Vote by Philip Booth

(St. Mary's University, Twickenham)
Vote: Raise Bank Rate by 0.5%; no more QE.
Bias: Keep raising.

Vote by Tim Congdon

(University of Buckingham)
Vote: Raise Bank Rate 0.5%; halt QE.
Bias: Neutral.

2016 saw a much too rapid increase in the M4x measure of broad money. It grew by 7.2% in the year to December, plainly too fast a rate to be consistent with the 2% inflation target in the long run. A fair generalisation is that the annual rate of broad money growth should not be much above 5% if the 2% inflation target is to be met. Not surprisingly, the pound has weakened and inflation will be higher in 2017 than in 2016.

However, money growth has slowed sharply in recent months. The annualised rate of M4x increase in the three months to January was only 1.8%. The explanation seems to lie partly in the strength of the public finances in recent months and partly in renewed weakness in bank lending to the private sector. (M4x is dominated by bank deposits. When the government runs a budget surplus, as it did in January, tax payments from the private sector's bank deposits exceed receipts from government spending. So bank deposits fall. In the normal course of events new bank lending creates new bank deposits. It follows that weakness in lending is associated with slow money growth.)

I am reluctant to be very definite about the reasons for the current apparent weakness in bank lending and it may indeed be a statistical illusion. (The Bank of England's data on the credit counterparts to M4, not M4x, reported a surge in lending of over £40b. in January. Evidently, there was a big loan – or there were a number of big loans – from banks to "intermediate other financial corporations". At the same time bank lending to genuine non-bank financial institutions dropped sharply. This rather strange pattern may mean nothing or it may presage a burst of new credit from IOFCs. Without a steer from the Bank of England, it is impossible to tell.)

As I have said before, the latest QE purchases are misjudged and should be halted. Given the pound's weakness, I am in favour of a 50 basis point rise in Bank rate. But in recent months the growth rates of both M4x and M4xL have been slowing, and it may be that banks are still restricting balance-sheet growth to meet regulatory restrictions. So, once the rate rise has been implemented, my bias is neutral until the situation becomes clearer.

Vote by John Greenwood

(Invesco Asset Management)
Vote: Raise rates to 0.5%; suspend asset purchases, but hold in reserve.
Bias: None.

Vote by Graeme Leach

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

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise 0.5%.
Bias: to Raise by 0.25% each month until rates reach 2%.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise 0.25%.
Bias: to Raise.

Vote by Patrick Minford

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

After their disastrous efforts ate forecasting doom and gloom from Brexit, the forecasting community has at last come to its senses and begun to forecast normally. The outlook among the key forecasters has moved to a growth forecast of 2% for 2017 for the UK, against an outturn for 2016 that has been revised down to 1.8% overall on the basis of a very weak (revised) first quarter. This is a surprising revision which may change yet again. But the basic point about it is that 2016 came in as a lamb and went out as a lion- so turning the 'Brexit Disaster scenario' on its head.

What to make of all this? Time and again the forecasters forgot the power of the exchange rate. For them it is all about the effect on the consumer price index, and not at all about the profitability of exports and import-substitutes. Yet go back to basic open economy macroeconomics and remind yourself that a large devaluation is like a large monetary stimulus that works by raising home producer prices relative to wages, with an impact on industrial profitability in selling to foreigners at the same dollar prices and in selling at home at prices that can rise to match much more expensively home-priced foreign products. No wonder that we have been hearing nothing but good news from industry, on sales, investment and output.

This devaluation has powered up an economy that was doing perfectly well already. On top of this world growth is strengthening, with even the euro-zone perking up and Trump's America straining at the leash and slavering over the prospect of an Obama-free world of deregulation and tax cuts. Interest rates are rising in the US; QE will continue for a time in the euro-zone but with inflation there over 2% this will not go on for long now. Here it can only be a matter of time before the Bank moves to tighten monetary conditions, if only modestly in 2017. Inflation here is already over 2% and likely to rise further over the next year as price rises filter through from the devaluation and also push up wages. The Liverpool Macro Research forecast is for growth over 2% in 2017; it could well get up to 3% or more depending on just how much wages respond. So far it looks as if the response will be fairly muted, and that money and credit have also not responded as strongly as they would have in a less regulated world. Rather like in the post-ERM period from 1992, when also there was a large devaluation, there may be enough cooling sentiment around, due to fear of the unknown, to prevent a precipitate boom.

Meanwhile it is salutary to look at a table of post-Brexit manufacturing profitability. (source: Patrick Minford and Edgar Miller, 2017, What shall we do if the EU will not play ball? UK WTO strategy in a non-cooperative continent, downloadable from www.economistsforfree trade.com)

	Home Market	**EU Market**	**RoW Market**	**Total**
Post-Brexit Home Market EU Market ROW Market manufacturing profits	(£100bn)	(£110bn)	(£115bn)	
Price Impact	-20%	0	0	
EU Tariff Impact	0	-3.5%	0	
Sterling Impact	+15%	+15%	+15%	
TOTAL	**-£5bn**	**+12.6bn**	**+17.2bn**	**+25bn**

Notes on Table: The WTO Option in our World Trade Model assumes that initially, following the loss of EU protection, UK manufacturing prices will fall by 20% in the home market compared with current EU prices but eventually over, say 10 years will settle to 10% lower than prices within the EU. This is because the EU is assumed to follow a slow trend towards reduced protectionism. It also assumes that our exports to the EU face the current EU MFN tariff but that a general pro-business industrial strategy support package is put in place by the government to allow industry to absorb this without putting up EU prices. The Sterling exchange rate has fallen about 15% post-Brexit. The total manufacturing home market is around £100 billion; total manufacturing exports to the EU are around £110 billion and to the ROW about the same at £115 billion. So while the exchange rate stays down, manufacturing makes profit gains of £25 billion, on total gross value added of about £160 billion equating to 16% extra gross margin on value added.

Manufacturing gets an immediate uplift once Brexit occurs of no less than 16% on its £160 billion value added, a huge rise in its margins. This is after assuming that the EU levies a tariff on UK exports, while the UK negotiates free trade

agreements with the Rest of the World implying that manufactures from the ROW enter here at world prices, 20% lower than current. It is no wonder that UK manufacturing is in high spirits.

My advice on monetary policy remains that interest rates should be raised by 0.25% in the next meeting, with a bias to continue raising; and that QE be discontinued and reversed gradually, with the aim of eliminating the whole Bank holding over the next five years.

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%.

Over the past year, measures of the UK broad money stock have accelerated noticeably. Cheap credit has become more and more available and offers of credit taken up more readily than for many years. Annual growth of M4eX peaked at 7.7% in September 2016, edging down to 6.6% in January. This reflects the dominant profile of the household sector component, which peaked at 6.8% in September and has slipped to 5.6% for January. Holdings of M4 by private non-financial corporations weakened over the past 15 months to reach annual growth of 5.2%, down from double-digits in 2015. Other financial corporations' holdings emerged from structural decline last summer to show a current growth rate of 11.8%.

The M3 estimate for the UK on the EMU basis is running at 7.4% growth; Divisia money stocks are soaring by 9.7% annually for the household sector and 10.7% for private non-financial corporations. Outside the M4 umbrella, foreign currency deposits at UK monetary financial institutions are rising strongly, up 10.9%, and private sector deposits at Channel Islands and Isle of Man institutions have grown 6% and 21% in sterling and foreign currency, respectively.

Meanwhile, the Barclays Basix Survey (Q1) UK found five-year forward inflation expectations of 3.9%, up from 3.7% in the previous quarterly survey. From virtually every direction, there is evidence of increasing monetary accommodation and inflationary expectation. Yet, reading the February Inflation Report, you would be hard-pressed to discover this reality.

In truth, the MPC has not the slightest intention to confront an overshoot of inflation, a prospect that has honed into view with the recent jump in headline CPI inflation to 1.8%. The Bank has become a cowardly agent of demand management with scant regard to its inflation mandate. Having survived the experience of the 2010-11 inflationary overshoot without serious reproach, it is inclined to repeat the experiment. "The MPC will monitor developments in the light of its inflation tolerance, and will explain its assessment and policy stance accordingly."

Over the past 8 years, the MPC has created an ever more daunting set of objections to be overcome before daring to raise interest rates. Curiously, they found no such difficulty before their unanimous decision to cut rates by a quarter-point last August. Despite the growing absurdity of that pre-emptive move – ostensibly to cushion the UK economy before it hit a hypothetical air pocket – the path to reversal of the cut is no less tortuous than for the prior, long-contemplated, rate rise.

During the summer of 2015, Bank governor Mark Carney put financial markets on notice for an early-year rate rise. His eagerly awaited "turn of the year" speech, just over a year ago, failed to deliver in spectacular fashion. His devastating finale was to list eight forces "that have kept interest rates depressed throughout the recovery and into the expansion": "demographic change, slower potential growth, higher credit spreads, lower desired investment and a lower price of capital, changes in income distribution, private deleveraging and lower public investment". He concluded that "the journey to policy normalisation is still young." Such was the extent of the climbdown that the money market curve pushed out the timing of the first Bank Rate rise 3 years into the future. It remains a distant prospect, with a fully-discounted rate increase delayed until 2019.

There is a longstanding debate in economics – paralleled in other disciplines – about the comparative merits of rules versus discretion. Should you tell schoolteachers exactly what to teach, how to teach it and how quickly to cover the syllabus? Or should you provide guidelines and handbooks and trust them to decide what will work best with their pupils? Should the Bank of England's Monetary Policy Committee have their hands tied by a rulebook, with sanctions for recalcitrant members? Or should they be allowed to exercise discretion over the way they pursue their mandated objectives?

Long before the inception of the MPC, in the early 1980s, the Thatcherite monetarist experiment experimented with target growth rates of the broad money stock. This may have been the closest that UK monetary policy has come to a rules-based regime. Since then, it has mutated into constrained discretion, as practised by Lord King, and thence into unconstrained discretion after the global financial crisis. Under Governor Carney's pragmatic and political leadership, unconstrained discretion is tantamount to institutional paralysis.

A year ago, Mark Carney severely damaged his credibility as a dispassionate executive of monetary policy. In August, he committed an honest blunder. The failure even to correct the error suggests that the threshold of proof that must be reached, before a majority on the committee will begin to normalise Bank Rate, is unreasonably high. Over the past 4 years, my vote has been cast almost always to raise Bank Rate and this month is no different. There is no compelling reason to leave rates unchanged and the likelihood of great mischief if they are not raised at the earliest opportunity.

Vote by Trevor Williams

(University of Derby)
Vote: Hold Bank Rate.
Bias: Raise if economy does not slow.

Money supply growth in the UK is showing signs of slowing down. UK GDP growth was revised up in the last quarter of 2016 to 0.7% quarter-on-quarter but the rate for the year as a whole was lowered to 1.8%. Admittedly, this is well above the 1.1% average of the 10-years to 2016, but well down on the preceding 30-year average of 2.8%.

The response of consumers following the EU referendum result in June last year to a 0.25% cut in bank rate and further QE, combined with a loosening of monetary policy (equivalent to 3-4 percentage point cut in Bank rate) from the fall in the exchange rate, meant a sharp rise in spending and as the saving rate fell.

This is unlikely to be repeated this year, amidst signs that consumer-spending growth is running out of steam. Employment is at a record high and the unemployment rate is 4.8% but no longer falling. Weak productivity means generally weak wage inflation and there are signs that despite rising price inflation wage inflation is off the boil. The steady-as-you go Budget has not changed the direction of the economy, embedding high government debt and the 'crowding out' of more productive private sector spending as far as the eye can see.

With this in focus, it is worth waiting to see what happens next before raising rates. I would have preferred if rates had not been cut, and they should be reversed, but it is now difficult to do so, just as article 50 is about to be triggered.

Policy response

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

2. Three members voted for an increase of 0.5%. All other members favouring a rise voted for an increase of 0.25%.

Date of next poll

Sunday, 7th May 2017

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 *Sunday Times* newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Rotating Chairman is Andrew Lilico (Europe Economics). Other members of the Committee include: Philip Booth (St Mary's University, Twickenham), Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffers), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (University of Derby).

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

www.iea.org.uk