IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes eight / one to raise Bank Rate in September

In its e-mail poll for September - the Shadow Monetary Policy Committee (SMPC) voted by eight votes to one to raise Bank rate. This decision marks the 4th consecutive month that the committee has voted for a rise by this margin.

The overwhelming consensus amongst members is that the economy is expanding fast enough to warrant an increase in interest rates. Rates at these levels were meant as an emergency response to much weaker economic conditions than is prevalent at the moment. Too low interest rates for too long are judged by many to be damaging to productivity, by supporting zombie firms, and to borrowers and lenders, by encouraging excessive debt accumulation and risk taking activities. Money supply growth and surveys of business activity seem to suggest that growth will remain healthy - albeit slower than a year earlier - even in the midst of uncertainty generated by on-going Brexit negotiations. At the very least, the majority view is that the rate cut last year, at a minimum, needs to be reversed as quickly as possible. The dissenting vote reflects a view that weak consumer price and pay inflation pressure, and uncertainty about how the Brexit talks will end, justify holding rates at their current level for a while longer.

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 regularly gathers 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.

Votes

Vote and Comment by Philip Booth

(St Mary's University, Twickenham)
Vote: Raise Bank Rate ½%.
Bias: Further increases.

Base rate should be raised by 0.5% immediately with a bias to continue rising.

The justification for the last fall never materialised and it should be reversed. Furthermore, both monetary indicators and any judgement based on output gaps would suggest that interest rates should normalise. The challenge is low productivity growth and, if anything, low interest rates reinforce this problem rather than help to solve this.

Vote by Roger Bootle

(International Monetary Research Ltd.)
Vote: Hold.
Bias: No bias.

Vote by John Greenwood

(Invesco Asset Management)
Vote: Raise Bank Rate ¼%. End QE.
Bias: Neutral.

Vote by Graeme Leach

(Macronomics)
Vote: Raise Bank Rate ¼%.
Bias: Neutral.

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%.
Bias: to increase rates further.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%.
Bias: to increase rates further.

Vote and comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Increase Bank rate by ½%.
Bias: Raise further, discontinue QE and reverse gradually.

For years now the cognoscenti of UK economics have complained about the current account deficit and demanded rebalancing; I include in their ranks Nick Clegg, Sir Vince Cable and the CBI, to name a few.

But when it happens as a result of Brexit and the resulting 15% devaluation, they complain again! Now because it was horrible Brexit that caused it, it must all be bad. They bang on about the effect on consumption without referring to the effect on exports, orders, investment and profits. The ONS has recorded weak first quarter GDP figures and the slowish second quarter ones just out; 0.3% after the revised 0.2% for the first quarter.

Yet this slowness is of course due to the effect on consumption of the ‘pass through’ of the devaluation into the CPI and its effect on real wages and private consumption. This is all straight out of the basic playbook of devaluation. Devaluation works to rebalance the economy towards a reduced current account deficit, more net exports, stronger manufacturing profits and more investment, precisely by reducing personal real incomes and consumption and pushing money instead towards producers of traded goods and services.

It is also a well-known feature of this process that there are varying lags in its operation. It tends to work faster on consumer prices and incomes than it does on producers’ net exports and investment. It may even worsen the current balance in the short run because the prices of imports go up rapidly with devaluation whereas export prices may remain set in sterling terms to pass the benefit of devaluation on to foreign buyers, to increase sales volume.

Another well-known feature of these events is that different parts of GDP get surveyed with differential precision in the short run. This is why GDP figures keep on being revised years after the event, as new data is gathered that better samples what was happening. Retail sales and consumer spending is probably most reliably sampled in the short term, apart from in bad recessions when sales go into new outlets promising better value to the harassed consumer. But output and export figures of companies get sampled poorly especially when there are changes in composition or new markets involved.

Yet the latest data suggests growth is better than the ONS is suggesting- a fairly usual occurrence. We have had bullish surveys from the CBI and the Bank's agents. The Purchasing Managers' Surveys- of manufacturing, services and construction- are all still confirming that steady growth is continuing; they are all well above the 50 mark in recent months. The latest ONS trade figures continue to record solid growth of exports - around 10% up in volume on a year ago.

The Bank is dragging its feet on 'renormalising'. Like other central banks it favours continued tough regulation on banks, without thinking through what this means for distorted lending flows. It needs to release the grip on bank balance sheets and simultaneously move to higher interest rates and a reduced balance sheet.

Vote and comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ½%.
Bias: To raise Bank Rate.

The UK's broad credit and monetary aggregates enjoyed a spurt of growth from mid-2015 after five years of virtual stagnation. It is tempting to infer from this development that the growth rates of private sector output and real household spending will remain robust, or at least resilient, over the next 12-18 months. This inference should be resisted.

Members of the Bank's Financial Policy Committee – notably Andrew Bailey and Alex Brazier – have been out in force recently to hammer home a cautionary message on household borrowing. Despite paltry annual growth rates of total mortgage lending (3.8% for June) and deceleration in previously concerning growth rates for non-mortgage lending (7 per cent, down from 10 per cent), the FPC is on the warpath. The Bank sees "some tentative signs of boundaries being pushed" and that "mortgage lending at higher loan to income multiples has edged up." The pitfalls – for car finance companies – of the promotion of Personal Contract Purchase (PCP) plans are worthy of serious consideration.

At the margin, the terms of consumer access to unsecured credit are tightening. The renewed squeeze on real after-tax household incomes has increased the demand for short-term bridging finance, but has simultaneously raised the risk profiles of likely borrowers. Meanwhile, mortgage borrowers are scrambling to procure cheap 5-year and 10-year fixed rate loans before the world changes.

All well and good that the FPC should be crawling all over developments in household borrowing and marginal forms of consumer credit. However, by far the greatest beneficiaries of easy credit conditions, made even easier in August 2016 in response to the EU referendum result, are financial intermediaries and large private non-financial corporations. The additional £60bn of quantitative easing helped to drive down gilt yields to absurd levels, from which they have since rebounded. The proceeds of opportunistic bond issuance are being held substantially as cash and short-term assets on financial and corporate balance sheets.

The anticipation of, and reaction to, the June 2016 referendum result have distorted the UK monetary aggregates in various ways, most notably to increase precautionary holdings of liquidity, whether in Sterling or foreign currencies. As companies seek to mitigate risks in multiple dimensions, it is rational for them to make provision for additional expenditures that may become necessary to preserve business continuity. We expect corporate liquidity ratios to remain elevated well into 2019.

Another context of significant borrowing expansion in the past few years is asset management companies and pension funds, although the tempo has slowed in 2017. While there are credible narratives to support this acceleration – increased use of securities lending, adoption of the risk-parity investment style, the increasing influence of private equity funds and the intermediation of lending to small and medium-sized enterprises (SMEs) – this does not amount to reassurance. Slack credit policies may well be storing up trouble in the financial sector.

Regardless of the detailed narratives underlying this surge in financial borrowing, there is a general point to make: that the extension of the regime of very low interest rates has incentivised a new wave of potentially dangerous leveraged expansion of financial activities. The failure to prioritise interest rate normalisation leaves the Bank wide open to criticism that it has fostered a boom in financial engineering. If financial asset prices suffer a material correction, the losses on financial loans could swamp those on household lending.

Despite the clear signs of economic deceleration in recent months, there is an overriding justification for higher interest rates – not only to reverse last August’s cut, but to signal the desirability of rate normalisation, whatever that means in this enchanted forest, and to head off dangerous uses of leverage.

Vote and comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: Raise Bank Rate ¼%. Start to unwind QE.
Bias: Neutral.

Evidence suggests that the UK economy is expanding by about 1½% a year, roughly in line with its potential rate and slowing from a year earlier. Whilst this is not inflationary, it is inconsistent with Bank rate of 0.25%. Money supply growth is solid, business indicators are holding up, unemployment is low and FX weighted export markets are growing. Hence, the need to unwind the loosening that took place after the referendum to leave the EU last year.

Growth in financial assets are strong – perhaps too underpinned by ultra loose monetary policy - do not require official support and so QE should begin to be reversed, starting with allowing the stock of assets held to be run down by not replacing maturing paper. Further rate rises may be necessary but that should be judged by the evolution of data in the period ahead, as there are downside risks for an economy entering the seventh year of expansion.

Policy response

1. On a vote of eight to one the committee agreed to reverse the Base rate cut following the Brexit referendum result and raise the rate by ¼%.
2. Five members voted to raise Base rate by 50bps. Three voted to raise by ¼%, and one was to hold.

Date of next meeting

To be arranged.

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 Trevor Williams (University of Derby). 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), Julian Jessop (IEA), Graeme Leach (Macronomics), Andrew Lilico (Europe Economics), 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).