IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes unanimously to raise Bank Rate in November.

At its October 2017 face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) voted unanimously to raise Bank rate in November. This outcome is the most decisive vote in well over ten years. Of the nine, six wanted to see an immediate hike of ½%, while three preferred to see a ¼% increase. But as well as agreeing that rates should go up, they also decided that the bias should be for further tightening. Concerning QE, three members explicitly said they wanted to see efforts to start to roll it back. One of the three was wary that if QE was withdrawn and money supply growth slowed as a consequence, this could tighten monetary policy too quickly, arguing for caution in raising rates.

Emergency-low interest rates can no longer be justified when the world economy is showing its best performance in ten years, and UK inflation is back to a five-year high. It is not that there is a severe inflation problem; we all know that there will be some fall back in 2018 when the impact of the decline in the pound drops out of the calculation. Instead, the key points are that the UK has weathered the shock of the Brexit vote much better than most had expected and that the precautionary cut to ¼% last August can now be reversed.

Indeed, it is high time that a move towards a more neutral level for interest rates gets underway. Raising rates will allow them to be cut in future when the economy may desperately need it. Few can argue that the critical issues facing the UK economy, from low productivity and low pay, to the effects of an aging population and the housing shortage, were caused by an overtight policy stance. If anything, excessively low interest rates are now contributing to these problems.

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.

Minutes of the meeting of 17 October 2017

Attendance: Phillip Booth, Julian Jessop (IEA observer), Graeme Leach, Andrew Lilico, Peter Warburton and Trevor Williams (Chairman).

Apologies: Roger Bootle, Tim Congdon, Jamie Dannhauser, Anthony J Evans, John Greenwood, Kent Matthews (Secretary), Patrick Minford and Anthony Valentinyi.

Chairman's comments: Trevor Williams welcomed everyone to the meeting, noted the apologies and then presented the monetary situation.

International monetary background

Trevor Williams started with the global economic outlook, examining changes in the growth of broad supply money M3 produced by the OECD using IMF methodology agreed with member states. Overall, for the main industrial and emerging economies, he found that growth rates of M3 were solid (this was to say rising sufficiently to support economic growth). This was consistent with the actual economic growth rates being exhibited, albeit with some important differences. For instance, growth rates of broad money M3 were faster in the emerging economies, particularly in China, than in the advanced economies.

The growth of broad money had improved in the Euro area, but remained around the 4-4.5% level, inconsistent with 2% plus GDP growth for any extended period of time. However, it was noteworthy that Eurozone growth this year was on track to be the best in a decade.

Using IMF economic forecasts made in October for 2017 and 2018, the trend of broad money was consistent with the best global economic performance since 2009. Low inflation, loose monetary policy including QE, and low commodity prices were combining to produce a cyclical recovery.

But economic forecasts by the IMF based on leading indicators suggest that the peak in the economic cycle may be close.

Trevor Williams noted the long term trend rates of growth of the emerging economies appeared to be further below their long run average, compared with how far the advanced economies are below theirs. He wondered whether this was made more likely - amongst many factors - owing to corruption.

A large economy like China would find it difficult to continue to grow as fast as in the past as it achieves middle-income status, i.e., moving further along the production possibility frontier. Trevor also noted that based on potential GDP – population and productivity - some advanced and emerging economies were operating below potential.

UK monetary, economic and political background

Trevor Williams turned to the UK monetary background, noting that growth in broad money was slowing, on an aggregate M4 basis. The good news was that the data did not suggest that the economy was about to go into recession. Growth rates of M4 of 4% to 6% were instead compatible with economic expansion of 1% to 2% a year. The bad news is that it may move closer to the lower end of that range this year and next.

Trevor highlighted that although remaining the largest category of M4, the growth of M4 holdings by the household sector was just 3% in the year to August, compared with 5.5% for the non-financial sector, and 7.7% for the 'other financial institutions'. This may be because household cash flow is under pressure from rising inflation as they try and maintain spending by lowering savings, while commercial companies are investing less than they could and 'other financial' firms, perhaps for precautionary reasons, are holding more cash in reserve. Trevor suggests that this may play to the slower economic growth trend that emerged this year.

With productivity stalling, Trevor wondered if slower gains were a result of a high proportion of firms that were surviving only due to the persistence of low-interest rates but that were undermining the productivity of firms that would invest more if their profits and allocation of capital were not being reduced by these firms.

Trevor noted that the UK's real product wage was moving in line with productivity, indicating that low pay was down to fundamental factors and was therefore not a sign of market failure. Weaker productivity gains meant weaker pay growth. A lower share of labour compensation should therefore not be a surprise.

Trevor drew attention to the fact that domestically generated inflation in the UK was weak. Above target price inflation was down to externally driven inflation from the fall in the pound and so will be reversed.

In concluding, Trevor said that, overall, the UK economy was not in bad shape. Unemployment was at a record low, the financial sector was stronger, inflation was not a serious concern, and the monetary data did not suggest that recession was likely.

The Chairman then invited discusion from members.

Discussion

Peter Warburton questioned the global inflation outlook, noting that his estimate of global inflation was higher than suggested in the presentation, at around 2.4%. Julian Jessop agreed. Recent low oil and other commodity prices may be sending a misleading signal about inflation pressure, based on three month annualied exptrapolations. Peter was also concerned about the rate of broad credit expansion in China. He pointed out that China's money supply growth is faster on his estimates than is shown by the OECD M3 series because of the shadow-banking sector that is not inclcuded.

Andrew Lilico challenged the view that global growth was 'solid,' and asked whether the number of countries showing weak or accelerating growth was a normal trend or whether it was more normal than that there would be more of a mix of contracting, slower growing and accelerating. Trevor replied that he had not seen the data back further than the ten years in the IMF chart so did not know what the mix was like across cycles.

Andrew Lilico asked whether the implication of the productivity chart - that it is well below its previous trend was wrong. Why not draw a new line of best fit through the whole data set rather than continuing the trend from the 2008 crisis and excluding what came after? This would make the gap disappear. Trevor pointed out that this would also make productivity lower on average and would imply that the trend in the past was unsustainable? He questioned whether that was true.

Philip Booth wondered whether we should trust IMF forecasts of economic growth at all, for this year or next, as their track record was so poor.

Andrew wondered if corruption could significantly weaken the growth performance of EM economies. Trevor said that evidence suggests that it does, as it leads to nonmarket factors influencing investment decisions and obscuring price signals - in other words, crony capitalism,

Graeme Leach highlighted that annual M4x growth was quicker than that of M4, but that the latest rate was still lower than at the start of the year, and it had been on a slowing trajectory through 2017.

Philip questioned whether any study could show that fixed income beats equities or other commercial assets over time, other than maybe in the last few extraordinary years of QE. He noted that the MPC was fighting the Financial Policy Committee (FPC). The MPC was keeping policy loose with record low bank rate and QE while the FPC was tightening policy via higher credit standards to curtail borrowing growth. It is no wonder that borrowers are confused.

The Chairman called the discussion to a close and invited the Shadow Monetary Policy Committee to offer their votes and comment.

Votes

Comment by Julian Jessop

(IEA observer)
Vote: raise rates ¼%.
Bias: To tighten.

In order of voting, Julian Jessop, who left the meeting early, was in favour of a rise of ¼%. He said it was high time to start normalising monetary policy. The economy was healthy enough and there was no reason for delay.

Rates are only as low as ¼% because of fears of a sharp downturn following the EU referendum, which has failed to materialise. To be sure, growth is weaker than it would otherwise have been, due to the additional squeeze on real incomes from the fall in the pound and the drag on investment from uncertainty about the UK's future relationship with the EU. But despite these headwinds, the GDP has continued to grow at an average rate of 0.4% q/q in the five quarters since the Brexit vote, which is only slightly slower than the pace in the five quarters before.

What's more, it is wrong to assume that ultra-low interest rates are good for the economy. A rate rise would help to put a floor under sterling, reducing the inflationary pressure from a weaker currency. Indeed, the longer that interest rates are kept at such low levels, the greater the cost from the misallocation of resources. Ultra-low rates may actually be undermining investment by forcing firms to divert more money to offset pension deficits and by encouraging banks to speculate in financial assets rather than lend to the real economy. They are also holding back productivity by keeping 'zombie' firms going.

The timing is right too. The bulk of the incoming economic data has matched or beaten the Bank's expectations in its August Inflation Report. A November rate hike is therefore now essentially priced in to the markets. In these circumstances, leaving rates on hold might risk sending the wrong signal – either that the MPC thinks that the economic outlook is actually worsening (which could undermine confidence), or that it will keep rates low come what may (which could simply boost inflation expectations and encourage more speculation). And with the Chancellor almost certain to loosen fiscal policy in the November Budget, there will be even less need for interest rates to remain low to offset the drag from 'austerity'.

Comment by Andrew Lilico

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

Andrew argued that a rate rise was long overdue. A quarter of a point increase was not enough to 'get ahead of the curve.' Not good enough to say that various circumstances have prevented the rise in the last few years. Bank Rate should rise by 50 basis points, with a bias to further rate increases.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ½%.
Bias: To raise Bank Rate in steps of ¼% to 1½%.

Peter said he has long argued for a rise and wants to see Bank rates go up by ½% immediately. He noted that the world economy was enjoying a pick up in nominal GDP growth. Unfortunately, the UK saw higher inflation and less real growth. The monetary policy stance has been left too loose for too long. Time to act and get on with the job of tightening. Canada resisted following the US in raising rates and is now seen being two rate moves behind where it should be.

Comment by Phillip Booth

(St Mary University, Twickenham)
Vote: raise by ½%.
Bias: To tighten.

The Bank of England should have raised rates three years ago. Now, it has to play catch up. The Bank of England has an inflation target and a mandate from Parliament to follow its remit. If it is not inclined to do so, it should say why. It is not for the Bank to decide whether meeting its mandate is the appropriate policy option. The UK's problems are not caused by an overtight policy stance. Low pay and low productivity will not be solved by low rates.

Comment by Graeme Leach

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

Graeme argued that broad monetary growth was still low and did not suggest the UK had an inflation problem. He thought that weak productivity growth equalled low pay growth and so muted domestic inflation pressure. Given the uncertainties, including around Brexit, the rate rise should be kept at ¼%. But he has a bias to tighten.

Comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: Raise Bank Rate ¼%.
Bias: Raise, start to unwind QE through non-reinvestment

The economy is strong enough to withstand a rate rise, and the Bank should raise base rate by ¼% with a bias to tighten. But it should also start the long process of reducing its balance sheet by not reinvesting proceeds from bonds maturing. As that is a monetary tightening, it should not do another hike until it sees how the economy develops. The current slowdown is partially cyclical – the UK was due one – and with the global economy growing, the UK is not significantly at risk from a sharper slowdown next year. But monetary tightening should, in my view, be slow, well signalled and gradual. If QE starts to be unwound as suggested, money supply growth should slow and so implies a shallower path for rate increases.

Comment by Kent Matthews (submitted in absence)

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%. Reverse QE.
Bias: To increase rates in stages.

In the aftermath of the Brexit vote, even the most hawkish of the members of the SMPC voted for a pause in rates to allow the market reaction to subside. Rational expectations tell us that outcomes from unexpected events are different from expected ones. The Brexit vote was a classic unexpected event. But over a year on, the economy is faced with a range of possible outcomes from a Brexit-lite scenario with a prolonged transition period, to a Brexit-clean scenario that comes into place on the date of departure. Meanwhile the build-up of liquidity in the economy continues with M4 growth in the 4-6% range in recent months. The time for the Bank to act on rates is fast approaching. The economic arguments for the rebalancing of rates towards normal levels are largely microeconomic. The gross misallocation of capital resources that come from the under-pricing of credit keep Zombie entities alive and starve healthy entities of growth funds, contributing to the lacklustre productivity growth of the economy. Inflation has reached the threshold of 3 per cent – much of this is the ‘one-off’ effect of the Brexit depreciation, but provides the appropriate cover for the Bank to act.

Comment by Patrick Minford (submitted in absence)

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

Volte-face

One of the ideas behind inflation targeting was creating predictability in monetary policy and enabling the 'forward guidance,' implicit in the target and the actions promised to make it happen, more effective. It must be said that the Canadian governor, Mark Carney's, tenure has been marked by a great downgrading of predictability. Governor Carney has been unable to resist the temptation to talk a lot about what he might do, and then promptly to change direction.

Only a few months ago the Governor was talking about prolonged monetary ease in the face of 'Brexit uncertainty.' This looked quite strange given that the economy was growing strongly throughout 2016, even if softer consumer spending was apparently reducing 2017 growth.

However, now the Monetary Policy Committee seems to have ganged up on him and reached a more robust view of the economy, closer to mine: that it is growing steadily and that ultra-loose monetary conditions look inappropriate, therefore. Effectively, monetary policy has been on 'emergency loose' status since the financial crisis struck hard after the Lehman bankruptcy in September 2008. The MPC has finally decided enough is enough: monetary policy must return gradually to normal as befits a normal economy.

To keep the Governor onside the argument is being put about on Brexit that the Bank 'cannot offset' the effects of a long-term regime change such as Brexit. This is rich considering the Governor has been arguing that it must on every possible occasion. However, it seems to have done the trick and the Bank line is now seamlessly to 'renormalise'.

To which I say Hallelujah! This process is coming online just as the Basel Committee adjusts to the Trump administration's demands for a softening of bank regulation- at last some reversal of the draconian demands for ever-higher capital injections into banks, with their result in the near-aborting of the recovery from the crisis, itself caused mainly by central bank incompetence.

So there will be a gradual raising of interest rates and an even more gradual selling-off of the huge amounts of government bonds held by the Bank (round about a third of the national debt). This must be welcomed as a step away from a market in savings that has been hopelessly mucked around by monetary policy: returns to savers have been tiny, while the government has paid negative real interest rates for its massive borrowing and medium to largish companies with weak prospects have been allowed to survive on essentially free money. All the while small companies where disruptive innovation is potentially strong have been denied credit because the rulebook says they are 'risky' and banks must hold a lot more capital when they lend to them. This has been a mad, bad world of credit.

Meanwhile the Brexit process continues on its inexorable course. The EU negotiators are not being cooperative so it looks as if getting agreement on trade and even on a transition period may be unobtainable. But Mr. Davis keeps on putting forward sweet reason, so putting the lack of progress firmly in the EU's court. It so happens that the UK benefits most from this lack of agreement, since without it we will go to WTO rules faster and so more quickly reap the gains from free trade and UK-based regulation.

It has never been right to bet against free trade and competition in Britain's long history. Brexit will be no exception. It remains the case that many sophisticated commentators have yet to catch up with the extent of EU protectionism and over-regulation. Getting rid of this while still selling to the EU across quite small tariff barriers, as is done by all non-EU countries of the world, will usher in a period of lower prices and more competition, the same recipe that gave us the Thatcher period of resurgent productivity.

Comment by Akos Valentinyi (submitted in absence)

(Cardiff University, Cardiff Business School.)
Vote: Raise ½%.
Bias: To raise. Gradually reverse QE.

I would raise the Bank rate by ½% with a bias to discontinuing QE and gradually reversing it.

Any other business

Following the vote, the committee discussed two proposals for letters to be written on behalf of the SMPC. Philip Booth proposed a letter about the abject failure of the IMF to forecast economic activity accurately, and that its forecasts, particularly of the UK, have been exceptionally poor. Hence, it should not have the influence and prominence it currently has amongst policymakers and others. Andrew Lilico suggested a letter proposing that new issuance of indexed linked bonds should be linked to CPIH rather than the RPI.

The Chairman suggested that both letters should be written and members could, as is usual, choose whether they wanted to add their name in support or not. Philip Booth and Andrew Lilico agreed to draft the letters and circulate to all members of the committee for their comments, and signature if they agreed, before publication.

Policy response

1. On a unanimous vote, the committee agreed to raise Base rate.

2. Six members voted to raise the Base rate by ½%. Three voted to raise by ¼%.

3. By convention, there is, therefore, a decision to raise rates by ½%.

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).