IEA Shadow Monetary Policy Committee

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For Further Information on the Content Please Contact:

Trevor Williams	+ 44 (0) 7841 497 791	trevor@trevorfwilliams.website
Andrew Lilico	+ 44 (0) 20 7269 2644	andrew.lilico@europe-economics.com
Julian Jessop	+ 44 (0) 20 7798 60192	rwellings@iea.org.uk

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Shadow Monetary Policy Committee votes to raise Bank Rate in December.

In its December email poll, the Shadow Monetary Policy Committee (SMPC) voted to raise Bank rate by seven to two. All of those that voted to increase Bank rate wanted to see ¼%. The bias of all nine members was for further tightening, but gradually.

Most wanted the Monetary Policy Committee (MPC) to continue a process they felt it should have started years ago. They argued that reversing last year's cut is not enough to tighten policy. Rates are still at emergency levels, and this situation is not justified by the current sub-2% pace of economic activity. One view is that slow UK growth is not a function of monetary policy but slow productivity gains and therefore cannot be tackled by low-interest rates. In fact, the low-interest rate environment of the last few years may have contributed to slow increases in productivity.

Decisions on interest rates should be based on the mandate of the MPC to keep consumer price inflation low and stable around 2% a year in the medium term. Focussing on key indicators like above-target inflation, fast growth in money supply and credit suggest that interest rates are currently too low.

Although the two dissenters agreed with the majority view with regards a bias to tighten, they wanted to see how the economy performs over the Christmas period and into the New Year before voting for a rise. They argue that money supply growth has been slowing since the spring of 2017 and that squeezed household income growth suggests that there is little inflation risk in the domestic economy. With that in mind, there is a high chance that the economy could slow further and that price inflation drops sharply towards the 2% target in early 2018.

Votes

Vote and comment by Phillip Booth

(St Mary University, Twickenham)
Vote: Raise by ¼%.
Bias: To tighten.

At last it seems to be coming to be acknowledged that the lack of economic growth is to do with low productivity growth and not to do with the monetary or fiscal stance. Other indicators suggest that continued tightening is appropriate. Belatedly, the Bank of England has started that process. They should continue it.

Vote by Roger Bootle

(Capital Economics Ltd)
Vote: No change
Bias: Raise rates by ¼%.

Vote and comment by John Greenwood

(Invesco Asset Management)
Vote: Raise Bank Rate ¼% to 0.75%.
Bias: To raise again.

The MPC's decision to raise rates by 0.25% in November has only partially corrected the error they had made in August 2016 in the wake of the referendum. Since it does not reverse the additional £60 billion tranche of QE implemented over subsequent months, nor does it end the Term Funding Scheme, which will run until the end of February 2018, monetary policy remains highly accommodative.

By the time of the referendum in June 2016 M4x growth was already accelerating, along with bank lending to the private sector. The result of the triple-barrel MPC decision in August that year was to exacerbate the monetary upswing, leading to an average growth rate of M4x of 7.0% p.a. between May 2016 and May 2017. Fortunately no great harm can come from a relatively brief period of excessive money growth, but the danger was clear. The Bank risked converting an episode of one-off imported inflation from the depreciation of sterling into a more sustained episode of domestically generated inflation.

Luckily for the MPC the growth of M4x has now slowed to 4.6% (in September 2017), but the growth of lending to non-bank financial institutions has surged to 13.1%. Meantime the increase in CPI inflation will continue to be higher than it would otherwise have been due to the

Bank's unwarranted easing in summer 2016. The unfortunate effect of higher inflation has been some erosion of consumers' purchasing power and hence an adverse impact on household incomes and spending in real terms. In addition, despite improved export orders there is some evidence of reduced investment spending due to the uncertainties surrounding Brexit.

To avoid another upswing in money growth or credit growth, a further hike in rates to 0.75% would be desirable. The upturn in loan demand both by non-bank financial institutions and by households suggests current interest rates remain too low. Interest rates therefore need to start being normalised by gradual increases that do not threaten either a credit squeeze or a sudden slowdown in the growth of M4x during 2018. The best way to do that would be to suggest that further rate hikes are in prospect.

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ¼%.
Bias: to increase rates further.

Vote and comment by Kent Matthews (submitted in absence)

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼%. Reverse QE.
Bias: To increase rates in stages.

Abandon caution and raise rates ¼%.

Vote and comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Increase Bank rate by ¼%
Bias: Raise further, discontinue QE and reverse gradually.

A number of commentators of the 'Remoaner' camp argue that Brexit is 'damaging the economy' by producing a slowdown in consumer spending as well as a fall in business investment.

Inconveniently for this story business investment has grown by 2.4% on a year ago, according to recently revised ONS figures. This is not fast but then the economy is not growing fast either and is well away from full capacity, besides still having access to a labour market also apparently with spare capacity. Then also the third quarter ONS estimates of GDP have come in higher than widely expected, at 0.4%, with manufacturing

growing strongly at 1% and finally coming into line with other indicators for the sector. The huge service sector has continued to grow moderately well at 0.4% in spite of some consumer slowdown. The ONS have now revised the first half growth rate upwards to 0.3%. It still looks out of line with other indicators, like purchasing managers' surveys and the ever-expanding labour market; and I expect it to be revised up further in due course.

The other problem with this story is that we have been running the economy at a huge current account deficit in recent years, of the order of 5-8% of GDP. This deficit seems to have emerged on the back of a very weak European economy to which our exports have accordingly slowed; and low returns on foreign investment, also perhaps connected to poor European profits, whereas UK profits have done fairly well with the recovery from the 2009 recession. This asymmetry of returns has soured our investment income account.

But whatever the reasons it was necessary for this external deficit to be corrected. Hence the Brexit devaluation has come in handily for this purpose. At a substantial 15% or so it is likely in time to correct this problem. The method by which it will do so entails a slowing of consumption as prices rise faster than wages, and an improvement in profits of exports and import-substitutes; this is known as 'expenditure-switching' designed to 'rebalance' the economy towards net exports. The very same commentators who have bemoaned the consumer slowdown as an evil Brexit effect have spent years in the past bemoaning our current account deficit and excessive consumer spending financed by over-fast credit growth. So now that Brexit has brought about a corrective, they should explain its corrective effects, not attack it. Is it too much to ask for some mature self-restraint and honesty among our commentariat?

Our forecast therefore shows the current account improving, the PSBR steadily going into surplus and the economy growing rather moderately at or around 2%, with inflation settling at 2%. Employment growth continues with the labour market yielding continued increases in participation, and measured productivity growth improves on the back of Brexit. Interest rates slowly rise to return monetary conditions towards normality. And this is only in the early years of the Brexit revolution.

Uncertainty redux

But there is a cloud on the horizon, as yet no larger than a man's hand… It is right to focus squarely again on the issue of uncertainty. During the Brexit Referendum the Remain side advanced the argument that Brexit uncertainty would cause a recession if there was a vote to Leave. Plainly this was wrong; there has been no recession. The uncertainty surrounding Brexit amounted to whether it would be a 'soft Brexit', close to the status quo, or a 'clean Brexit'. Since a 'clean' Brexit would mean moving the country to general free trade, its own regulation and restoration of control over unskilled immigration, all of which we have calculated would give the economy a substantial gain, this uncertainty amounted to possible outcomes that ranged from no change to large gains- uncertainty on the

upside, hardly likely to inspire fear. This uncertainty could be assumed to be eliminated quickly by a clear government choice of one or the other.

Nevertheless we are now, a year and half on from the Referendum, facing a different sort of uncertainty: that of a government seemingly unable to resolve internal disagreement about which choice to make. One group favours soft Brexit which is essentially the status quo, a negation of what was decided in the Referendum, namely to return power over trade, regulation and migration to the UK; the other favours clean Brexit. It could well be that this disagreement will continue for several years, with the ultimate decision being constantly kicked down the road.

This sort of uncertainty is potentially extremely damaging. It resembles ‘planning blight’ where a road is marked as due to be developed but the development is constantly deferred as the council authority argues over future plans. Here the existing residents will not invest and nor will any developers invest either; the road rots and falls into squatting and decay. The UK also faces this blight if the government does not take firm decisions on these policies. Those who see a bright future in free trade will not commit; those who want the status quo but fear it will not continue will also not commit.

Those, like the supposed ‘Hammond Treasury faction’ in the Cabinet, who want a soft status quo Brexit, justify their stance as not going against the people’s will in the Referendum but rather as implementing Brexit in the national economic interest: ‘people did not vote for an impoverishing Brexit’ is their cry. However this is pure sophistry for two reasons. The first is that the Referendum was indeed about ‘taking back control’ of laws, trade and borders; this simply cannot be denied, as this was the debate in terms. The second is that the claims of ‘impoverishment’ by a clean Brexit have simply not stood up to the facts since the Referendum, as we have noted above. There has not been the claimed recession and the slight slowdown the ONS has so far estimated is based on soft data and reflects the much-needed adjustment away from the consumer towards profits and net exports. On the long term effects of the Brexit regime change the Treasury’s calculations look increasingly threadbare: they are based on the idea that the ‘gravity model’ is against free trade with the world as a whole, which is untrue. Furthermore, UK trade facts support the broader classical model against the gravity model, in any case. For the Treasury to range itself against global free trade, some deregulation and the elimination of a large subsidy to EU unskilled workers is a bizarre policy position. The Chancellor and his Treasury team would be doing themselves and the Treasury a big favour in putting an end to it.

By doing so most importantly of all they will end the blight with which the current policy uncertainty threatens to sandbag the economy.

Fiscal and Monetary Policy

In a curious crab-like way the Treasury and the Chancellor appear to be positioning themselves for just such a move. The OBR’s absurdly gloomy forecasts for the Budget essentially led the Chancellor to do what he wanted anyway and strike an optimistic pose in his Budget.

In an interview with Bloomberg, Tom Scholar, the Treasury permanent secretary noted that in the event of a sensible deal with the EU, now looking more likely, the outlook should be much better than the OBR's. It therefore now seems reasonable to believe that policy is moving onto the front foot, with the view that there will be both free trade and a free-trade deal with the EU of a sensible sort. This will lead to a lifting of both the uncertainty described above and also of the relentless Treasury campaign to spread gloom about the economy's prospects. This in turn will lead to more constructive fiscal policies to strengthen competitiveness after Brexit through tax cuts and spending on public services. The debt/GDP ratio is already falling from its 80% peak (forget the nonsense about the Bank's 'debts' to the banks, which are of course money) and will continue to do so steadily, allowing this loosening of the purse strings- for more details see the 'Red Book' of Economists for Free Trade at their website.

So what to do about monetary policy? We need to follow this more optimistic and realistic view about the economy and continue to tighten monetary conditions towards a 'normal' state. Money is 'emergency loose' still; clearly this cannot be justified. The Bank holds around 36% of GDP in the government's debt (so that the Treasury as the Bank's owner in fact owes in debt only about 54% of GDP) and it really should get rid of it, pushing the gilt market into also a more normal yield situation. This has all to be done gradually. But the direction of change cannot be in doubt: raise rates gradually and slowly liquidate Bank gilt holdings.

Vote by Peter Warburton

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

Vote by Akos Valentinyi

(Cardiff University, Cardiff Business School.)
Vote: Raise ¼%.
Bias: To raise. Gradually reverse QE.

Vote and comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: Hold.
Bias: Raise by ¼%. Tighten by unwinding QE through non-reinvestment

Economic growth is slowing to a sustainable and non-inflationary pace of 1% to 1½% a year. The UK economy is expanding at less that half the global pace. As such, its rate of pay inflation will not take-off. Consumer

price inflation will fall back to target in 2018 and 2019. Monetary supply growth is slowing. Annual M4ex money supply growth in October 2017 was 4.2% compared with 7.3% in April. Caution on increasing rates might be sensible until February 2018, to see out the end and start of year volatility.

Policy response

1. On a majority vote, the committee agreed to raise Bank rate by ¼% to ¾%.

2. Seven members voted to raise the Bank rate by ¼%. Two voted 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. A briefer e-mail poll is released in the intermediate months when the minutes of the quarterly gathering are not available.

The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. 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 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), 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).