

# Shadow Monetary Policy Committee

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16<sup>th</sup> January 2018

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

For a second consecutive meeting (16th January), the Shadow Monetary Policy Committee (SMPC) voted unanimously to raise Bank rate in February. Six of the nine wanted to see a rise of ¼% and three an increase of ½%. Furthermore, there was a unanimous bias to tighten. One wanted to see QE reversed, worried about the mispricing of risk in financial markets owing to central bank injections of liquidity and active buying of bonds.

Much of the desire for higher rates stems from the on-going strength of the global upswing and the belief that it will underpin the UK's economic performance. But more directly, it was felt that the UK's economic growth of close to 1¾% to 2% signalled that it no longer required ultra-low interest rates that were put in place to prevent the economy sliding further into recession following the global financial crisis.

Indeed, low official rates are now leading to too high financial market asset price inflation in some areas and distorting investment behaviour and inhibiting productivity. Also, above-target inflation, further falls in unemployment and a better than expected economic performance post the Brexit vote means that a move to normality in interest rates should get underway while growth seems robust enough to allow it.

That said, the consensus view on the SMPC of where 'normality' now is for Bank rate is well below its previous average. The range is anywhere between 1½% and 3%.

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.

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## Minutes of the meeting of 16 January 2018

**Attendance:** Jamie Dannhauser, Phillip Booth, Roger Bootle, Julian Jessop, Graeme Leach, Kent Matthews (Secretary), Peter Warburton and Trevor Williams (Chairman).

**Apologies:** Tim Congdon, Andrew Lilico, and Patrick Minford.

**Chairman's comments:** Trevor Williams welcomed everyone to the meeting, noted the apologies and invited Julian Jessop to present the economic and monetary situation.

### International background

Global economy in strong synchronised recovery

Julian Jessop said that his presentation would be less about monetary trends and more about the real economy. He referred to the presentation material and noted that it was made up of four parts. First, he would say something about the global economy. Second, he would focus on the UK economy, and Brexit would naturally be a feature. He would then examine the inflation outlook and finish with a few concerns.

...inflation impulse already peaked.

The global backdrop is positive regarding activity with manufacturing PMI in both the advanced economies and emerging markets growing strongly. The downside of this positive picture is that the recovery in the world economy has fuelled a resurgence in commodity prices. Pointing to the next chart, he said that we have already passed the peak in sterling oil price inflation and UK transport price inflation. So while the oil price level is high, he said he was sanguine about the inflation outlook in 2018 even, if oil prices were to rise further, as evidenced by the recent figures for producer input price inflation.

### UK economic background

GDP growth accelerated in 2017...

Julian Jessop said that what he really wanted to do was to concentrate on the UK economic situation. Turning to the chart of UK PMI and GDP growth he referred to his favourite statistic, which is that GDP growth in the five quarters since the Brexit referendum is the same as GDP growth in the five quarters before the referendum. It is hard to see where on the chart the referendum had had an impact on GDP growth. Certainly, it affected sentiment as noticed in the sharp turn-down in the PMI index. Figures for the 4th quarter GDP growth are not available as yet, but NIESR's estimate 0.6% growth. On this basis, GDP growth has accelerated through 2017. The counterfactual of whether growth would have been stronger in the absence of the referendum is debatable, but talk of a sharp slow-down is wrong.

It is true that the UK has slipped down the league table of the world economies since the referendum, but there is no reason to believe that the UK should always be at the top of the league table. UK manufacturing is not doing as well as the Eurozone manufacturing, but the UK was above the Eurozone for some years. So what this looks like is a catch-up phase by manufacturing in the Eurozone area again with no significant Brexit effects observed.

... economy not behaving according to the predictions of 'project fear'.

Turning to charts from the ONS on short-term indicators, it is seen that the construction sector is in technical recession with two-quarters of negative growth. Notwithstanding the problems of Carillion this sector has been ahead of services and manufacturing for some quarters and is now converged on improving trends in the other sectors.

The trade performance has improved with the exchange rate adjustment post Brexit. The negative effects on imports have come through immediately as expected with more of the positive effects coming through in 2018. Unemployment also continues to fall, and it should be noted that it was about 5% at the time of the referendum and 'project fear' had predicted a rise to 6%, but it is now 4% and could even fall further.

Productivity improvement but no turnaround.

The jump in productivity in the 3rd quarter was nothing much to get excited about. The data on output per hour shows that productivity remains a long way below its pre-crisis growth trend. Partly this is a cyclical story with lots of cheap labour coming on to the labour force. As the labour market tightens, employers will have to use workers more efficiently, which might see an improvement in the future.

Turning to inflation, Julian said that headline inflation is uncomfortably high, but this is to do with the pass-through of the exchange rate, which will drop out in the future months. The headline rate is likely to head back to 2.5% by the middle of the year or 2% depending on what happens to oil prices. 2018 could be the year of a sharp fall in inflation.

Earnings growth of continuously employed at 4%

On average earnings, there have been composition shifts that have driven the figures down. People who have been unemployed have re-entered employment at less than average wages, and there have also been retirements of high earners. The earnings figures of the continuously employed have grown at about 4%. Potentially there is a positive story here to buttress household spending

Looking at the household saving ratio, there are two measures – the cash basis and the national accounts basis. The latter has various imputations for indirect measures of financial services, imputed services, and pension contributions etc. He prefers the straightforward cash basis and noted that while household debt had increased, looking at the figures over the long view, the numbers do not look as scary as the media suggests and it is not apparent that there is a fundamental problem. Jamie Dannhauser said that there could be significant revisions to household income, given the difficulty the ONS appears to be having in capturing the income of sole proprietors, which will see the ratio revised upwards in 2016 and 2017 bringing it closer to the 2014-15 figures.

Labour market concerns

Coming to potential concerns, the first is the movement in house price inflation which remains at 5% throughout this recent period and continuing to outpace income growth, helped by low-interest rates. However, there has been some regional rebalancing. Next, the labour market, where the number of people in work has begun to grow more slowly and hours worked flattening. Some economists have interpreted this as evidence of a slowing down of the economy, but Julian said that his interpretation is that as we approach full employment, this slowing down is a natural consequence. For this reason, he said that he turned to survey evidence.

The recruitment agency survey index shows that the demand for permanent staff and improvement in permanent salaries is improving against the backdrop of deteriorating staff availability. Similarly, survey measures of employment intentions show healthy growth.

Brexit uncertainty lifting

Finally, uncertainty around Brexit. Generally speaking, uncertainty seems to be lifting. Even the FT has significantly scaled back the number of job losses predicted for the City. The only exception is the Deloitte CFO survey that shows that after a general improvement since the referendum, there is a marginal worsening of intentions in the 4th quarter of 2017, suggesting that as Brexit approaches companies are getting more nervous.

Business investment growth, which has traditionally been volatile, has not moved and therefore investment levels have been low but stable, and these numbers are being revised up by the ONS. Jamie Dannhauser added that compared with

advanced economies capital spending has been weak and behind the global upswing.

In conclusion, as this has been a period of uncertainty, investment has been put on hold. The attitude of those who said that the economy would be 1% worse off is the assumption that the economy will continue to be 1% worse off. Two things that have been a drag on the economy that will be reversed shortly are: first, the benefits of the devaluation will come through in 2018; second, the projects that have been put on hold will also come back. Therefore GDP growth of about 2% in 2018 is his prediction. Phillip Booth said that in addition to general uncertainty there is policy uncertainty and that the economy could face more regulations outside the EU.

The Chairman thanked Julian for his commentary and then invited discussion from members.

### Discussion

Financial market  
bubbles and  
bond markets

Graeme Leach said that there were all sorts of measures of financial market bubbles that are flashing warning signals and asked what are the risks associated with the bursting of the financial bubble? Julian Jessop said that the equity market is overvalued by any normal measure, but even with a fall of 10-15%, it would still be higher than what it was a few years ago. He said that he was more concerned about the bond market and the prospect of a big sell-off in the bond market. In an environment of synchronised monetary tightening and tapering by the ECB, he could see that there is the potential for a bond market sell-off, notably if worries about debt sustainability returned and the case of a Corbyn victory in the UK.

Roger Bootle said that he agreed with Julian's assessment but that we needed to look at a stage earlier than a bond market sell-off. He said that there is a need to think about policy and short-term interest rates. He said that central banks and the markets are collectively behind the thrust of events in recognising the strength of the recovery. If the consensus in the UK is that growth is going to be weaker next year than last year, generally across the advanced economies, the danger is that central banks are failing to recognise the strength of the recovery. He added that he also agreed with Julian's concern about the housing market and the effects of a rising interest rate on a highly leveraged market.

Housing market  
concerns

Jamie Dannhauser said that some of the Bank of England micro analysis suggests that the distribution of mortgage debt has shifted higher up the income scale, such that the cohort of highly leveraged borrowers now looks "less risky" than was the case ahead of 2007.

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

### Votes (in the order given)

#### Comment by Phillip Booth

**(St Mary University, Twickenham)**

**Vote: raise by ½%.**

**Bias: To tighten.**

Phillip Booth said that the obsession with deflation in the early 21st century in the US had contributed to the build up to the crash. This was combined with a view that asset prices should not be allowed to fall and should be supported by monetary policy. He said that he was sanguine about a fall in asset prices and that

markets can deal with these shocks adequately unless they impinge on the banking system. The big question was how far equilibrium real interest rates had fallen because of demographics, changes in global saving etc. However, there remains a lot of room to raise interest rates before we get to the point that real interest rates are higher than that driven by real factors. He said that interest rates should be increased by a quarter to half of one per cent and voted for a half per cent rise.

#### **Comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: Raise Bank Rate ½%.**

**Bias: To raise bank rate in steps of ¼% to 1½%**

Peter Warburton said that there was less momentum carried over to 2018. He said that Internet sales had grown at the same rate as sales in shops and that he was less confident of a bright consumer outlook and a strengthening economy. He said that he was brightened by the acceleration in wage growth, but he felt that inflation would not fall as fast as Julian said that it would. He is less sanguine about the domestic outlook. Nevertheless higher interest rates are inevitable. There is a positive global outlook, which is better than the outlook for the UK, and, on the basis of that, there is scope for catch-up in policy, and he agreed that interest rates should rise by half per cent.

#### **Comment by Julian Jessop**

**(Institute Of Economic Affairs)**

**Vote: raise rates ¼%.**

**Bias: To tighten.**

Julian Jessop said that he was torn between a quarter per cent increase and a half of one per cent. On balance he said that he would go for a quarter than a half. There are two reasons for this are about timing. Most people expect no more than two increases this year. A quarter-point now is more than what the market is anticipating, and that would be sufficient to signal the move in policy. The Brexit uncertainty also warrants a quarter point rise rather than a half, which might frighten the market unduly.

#### **Comment by Graeme Leach**

**(Macronomics)**

**Vote: Raise Bank Rate ¼%.**

**Bias: To tighten.**

Graeme leach said that a vote for a 25 basis point increase in the base rate reflects the Bank of England's conditioning path for UK interest rates, which foresees a further 25 basis point increase this year and next. This gentle upward path assumes that inflation won't surprise on the upside and will return towards the 2% target in 2018-19.

There is a case to be made for no rate rise, based on the weakness of broad money M4<sup>x</sup> growth, which is increasing by less than 5% (yr-on-yr). Historically base rate rises have been associated with double-digit broad money growth – too late. However, the late cycle froth exhibited in asset markets strongly suggests the need to head off market bubbles in 2018, lest they inflate further, only to bust in 2019.

Whilst the relatively benign CPI inflation story has much to support it in 2018, we should not ignore the potential upside risk moving forward into 2019, in the wake of potential economic and political developments. Potential risk factors include: (1) Post-Brexit sterling weakness could return if EU negotiations worsen and/or expectations of a populist Corbyn Government increase. (2) Faster global economic growth could send oil prices significantly higher, with Brent crude increasing above \$75 per barrel. (3) Some form of Phillips curve relationship might emerge over 2018-19, despite evidence to the contrary thus far. (4) Stronger wealth effects emerge from equity and property market prices.

Of course, if the global equity market boom turns to bust, the inflation risk would switch from upside to downside.

### **Comment by Kent Matthews**

**(Cardiff Business School, Cardiff University)**

**Vote: Raise Bank Rate by ½%. Reverse QE.**

**Bias: To increase rates in stages.**

Kent Matthews said that he had consistently voted for a rise in rates of half per cent for some time. He has heard nothing in today's discussion to change his mind. There is unanimous agreement that interest rates need to rise and signal that monetary policy is on the path back to normality. The differences between members are about, when rates should rise, by how much, and how frequently. We are told that the markets are anticipating at least two rises, possibly of a quarter per cent each, sometime this year. For as long as rates remain unchanged, the markets enjoy a positive monetary impulse, with all the consequences for asset markets. If monetary policy is to have any effect, the Bank needs to inject a negative monetary impulse, which means raising rates by 50 bps now. Interest rates can always come down in response to negative external shocks. But they have to come down from somewhere. He also reiterated the microeconomic arguments of low-interest rates resulting in the allocative inefficiency of credit. He voted to raise rates by half per cent and to keep raising rates in small steps.

### **Comment by Jamie Dannhauser**

**(Ruffers)**

**Vote: Raise Bank Rate by ¼%. Provide overt signal of gradual tightening cycle.**

**Bias: To increase rates further.**

Jamie Dannhauser said that he would vote for a quarter-point rise and was comfortable about signalling further increases in the next few quarters. He said that the economics commentariat had underestimated the strength of the global upswing. He said that he was encouraged, but nonetheless surprised, at the broad base of the global upswing across countries and sectors. The ECB has recently talked about moving from recovery to expansion. He said that the figures for 2018 are likely to be better than 2017 and he challenges the consensus view that 2018 growth rates (with the exception of the US) will be weaker than in CY17. Britain is a small open economy that has historically been sensitive to the global cycle, and he said that he is uncomfortable with the continuation of emergency monetary policy, when the global backdrop is as good as it has been for than a decade. He said that he was less sanguine about Brexit than other committee members. Even if the level of trend output is unchanged in the long-run (which seems unlikely), there will no doubt have to be a sizeable reallocation of factor inputs in the economy from non-tradeables to tradeables, and that process will not be painless.

Even those optimistic about the supply-side effects of Brexit should acknowledge the short to medium-term disruption that such factor reallocation will cause. He said what was lost in the wider regulatory discussion was the improvement in the soundness of the core banking system, and that he shares the view that a drop in equity markets and disruption in corporate debt markets can occur without it being transmitted to the banking sector and recession. Now is the time to signal to markets that the emergency levels of stimulus are to be gradually withdrawn and make explicit a signal that UK interest rates are to continue to rise in the coming quarters.

### **Comment by Roger Bootle**

**(Capital Economics)**

**Vote: Raise Bank Rate by ¼%.**

**Bias: To raise.**

Roger Bootle said that he would vote for a quarter-point rise with a bias to rise mainly because of the effect on the exchange rate. He said that he did not want to get too out of step with the USA. On the point about bubble behaviour, he said that if there are bubbles around that is an argument for doing something about it early on. Concerning the housing market, it is a clear area of massive distortions from low levels of interest rates. People with money are putting them into housing because of the low returns on saving instruments. So to bring on interest rate rises cautiously and soon.

### **Comment by Trevor Williams**

**(University of Derby & TW consultancy)**

**Vote: Raise Bank Rate ¼%.**

**Bias: Raise, start to unwind QE through non-reinvestment**

Trevor Williams said that he votes for a quarter-point rise with a bias to tighten cautiously. He also wanted QE to start to be reversed through the non-reinvestment of proceeds from maturing bonds. He said that he was not convinced that banks are well capitalised. He also said that there remains considerable uncertainty in financial markets. Fundamental values of equities and a range of other financial assets are unknown – clouded by central bank intervention - so it is not clear that current pricing reflects the real underlying risks that investors are taking. Furthermore, there is considerable policy uncertainty about a range of issues in the UK, but mainly relating to the final shape of the Brexit outcome. Nevertheless, he said that there was room for a quarter-point rise now but to proceed cautiously with future rate rises.

### **Comment by Andrew Lilico (in absentia)**

**(Europe Economics)**

**Vote: Raise Bank Rate by ¼%.**

**Bias: to increase rates further.**

With UK GDP growth steady if unexciting, inflation above-target but falling and unemployment at a multi-decade low, it is clear that last November's first interest rate rise for ten years did not cause any significant disruption. That should give us the confidence to raise rates again, still by a modest 0.25% and still keeping a close eye out for any significant disruption associated, but taking the opportunity,

we have to seek some normalisation back towards a still-very-low level of 1.5 to 2% over the next year or so.

Higher rates should help to enhance productivity growth. They should lead to a slight rise in the value of sterling, taking the edge off above-target inflation. And they should drive faster medium-term GDP growth since economies grow fastest over the medium-term when interest rates are at their natural equilibrium level, not when they are kept artificially as low as policy-makers can get away with.

**Any other business**

There was no other business.



## Policy response

1. On a unanimous vote, the committee agreed to raise the Base rate. All those at the meeting expressed a bias to tighten and to continue raising rates.
2. Six members voted to raise the Base rate by  $\frac{1}{4}\%$ . Three voted to raise by  $\frac{1}{2}\%$ .
3. The majority decision of the Committee, therefore, is to recommend a rate rise of  $\frac{1}{4}\%$ .

## Date of next meeting

17th April 2018

## 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).