Shadow Monetary Policy Committee

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

An email poll of the Shadow Monetary Policy Committee (SMPC) in March produced a vote to raise interest rates by nine to nil. All nine members voted for ¼% increase to a Bank rate of 0.75%. The bias of eight members was for further tightening and one for a neutral stance.

All members saw the need for a rate rise to give room for cuts later on, to make up for the delay in raising rates and to counter the potential of future inflation. Despite a weaker performance than the EU the world economy, the UK economy still managed to expand by 1.8% last year. This year, economic growth of around 1½% is expected by the consensus of independent forecasters and by the Treasury. Although growing slower than in the year before, with a potential growth rate of under 2% the UK may have used up its spare capacity in the period of continued expansion since 2010. This opens it up to inflation risk, even as growth slows to around the 1½% a year mark. With the widespread view on the committee that interest rates are some 1% or so below 'normal' – further rate rises can be justified.

One member may want a pause in rate rises if signs of consumer price inflation slowing to the 2% target combine with muted wage inflation pressure and a slowing economy to suggest a diminution of price inflation risk in the years ahead.

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Votes

Vote by Phillip Booth

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

Vote by Roger Bootle

(Capital Economics Ltd)
Vote: Raise ¼%
Bias: Raise rates.

Vote and comment by Jamie Dannhauser

(Ruffer Capital)
Vote: Raise Bank Rate ¼% to ¾%.
Bias: To signal that Bank Rate needs to rise faster and further than current market pricing.

Given the central outlook for inflation, and the risks around that profile, UK monetary policy is too loose. The MPC should not have eased its policy stance in August 2016, after the Brexit vote. It should have waited to see how business confidence, and economic activity, would evolve once the dust had settled. In hindsight, it is apparent that early indicators massively overstated the extent of the growth slowdown and the willingness/ability of UK firms to pass on the cost inflation due to Sterling's slump. There is little doubt that the Brexit process has restrained UK growth - it has weakened in the face of the most robust global growth backdrop in over a decade. But growth remains moderate and no worse than the economy's (reduced) speed limit. Indeed, a significant amount of labour market slack has been used up *since* summer 2016.

Headline and core inflation remain well above target, partly because firms have passed on the higher cost of imported parts and final goods. But it is too sanguine to argue, as the MPC does, that it is exclusively down to GBP's fall. For one thing, the willingness and ability of firms to pass on higher import costs is itself a function of the state of the economy: high and rapid pass-through, as we have seen, is a signal that firms have the ability to push through price hikes, rather than absorb the cost shock into margins. Moreover, component-level CPI data show a marked rise in inflation amongst products with the *lowest* import intensity. When it comes to wages, the critical input cost at the macro level, there *is* clear evidence that a tight labour market is bidding up the price of labour: for the *marginal*worker, ONS data suggest pay growth is back to its pre-GFC level; and when it comes to average pay across the economy, we are finally seeing more robust gains, especially when set against the continuing poor productivity performance.

All told, the risks that CPI inflation remains above the target over the medium-term are elevated – in this author's mind, more elevated than the MPC believes. It is prudent, especially in managing market expectations about the future path of rates and inflation, to withdraw stimulus *now*, even if we cannot yet see the "whites of the eyes" of inflation.

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ¼%.
Bias: to raise.

Steady growth and a muted reaction to the November rise suggests there's ample scope for further normalisation without economic turmoil. In addition, inflation seems stickier than anticipated and some extra rate-rise-driven sterling strength could counter that.

Vote by Kent Matthews

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

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.

The Trump effect

Times and mores change; today we have the social media, prominent in politics. But the way Trump is simultaneously criticised and patronised by the ‘liberal’ commentariat is similar to the way Reagan was criticised and patronised by it. However, Reagan achieved a major conservative revolution in policy and also stimulated the economy with a major tax-cutting package; he famously pretended to be not very smart but this was for him the secret of his electoral success, as being seen as ‘smart’ is no way to win votes in the USA. Fast forward from the 1980s to today and Trump embodies similar tactics, updated for social media and today’s tiny attention spans. He produces a daily theatre for his core supporters, designed to entertain them and keep them in the loop, convinced that he has not become a Washington swampy. Meanwhile he has managed at last to create a cadre of loyal and highly competent administrators around him, led by vice-president Mike Pence. He has also used the bland arts of political good fellowship to strike up rapports with Republican Congress people. This is all out of the classic Reagan playbook, merely updated.

The Trump tax package is highly significant and cuts taxes all the way down the scale, cutting back on deductions and mostly doubling thresholds. The achievement of finally getting sense into the US corporate tax, and jettisoning its ‘worldwide’ tax base in favour of simply taxing US corporate profits, is a big one. Personal tax cuts are less dramatic but they confirm the US as a low marginal tax rate economy: they are being cut, not raised as almost everywhere else.

In a concession to concerns about the US public debt, now 100% of GDP, and due to rise by $1 trillion (5% of GDP) from the tax package, some of the tax cuts are supposed to lapse in the mid-2020s. But they will almost certainly be renewed, as taking away personal gains from people is impossible politics. How worried should investors be about US government solvency? Not very. First of all the Federal Reserve, America’s central bank, holds assets of $4.5 trillion, nullifying nearly a quarter of the US public debt. That will gradually be sold off but until it is, the public debt/GDP ratio is correspondingly reduced. Also the ‘secular stagnation thesis’ is well and truly buried now by the obvious surge in

US growth, accompanied by finally stronger wage rises. Growth in nominal GDP could reach 5-6% a year, which will reduce the debt burden.

At the same time the Trump administration is moving strongly on a deregulation agenda. The result is that growth is becoming stronger particularly in energy-producing and financial sectors.

We have yet to see how the infrastructure and Obamacare-reform programmes roll out. Fortunately for the Trump administration a new triad of Amazon, Berkshire Hathaway and JP Morgan are moving into the healthcare sector which is ripe for disruption, with inefficient and monopolistic practices rife throughout it. Against this background reform and even abolition of Obamacare looks more promising. On infrastructure there are major possibilities for using private sector arrangements that allow charging or shadow-charging systems so that government does not have to do it itself. Even road pricing these days has become technologically feasible via satellite tracking.

Much is made of Trump's supposed stance against free trade. However this is more to be seen through the lens of a large trade player retaliating against unfair trading practices which worsen its terms of trade. We are in the realms of 'optimal tariff theory' here, especially with some of China's practices in areas such as intellectual property rights. We should not confuse the interests of a large player in resisting bad foreign practices, with the interests of small players like the UK in a generally robust WTO system. The WTO is not well set up to deal with the large bilateral abuses with which the US is concerned. Court cases between large players such as the US and the EU (on GM foods for example) have been long and tedious and have failed to lead to resolution, even when there has been a judgement (as on GM foods in 2006).

In sum, it does seem fair to say that America is back as a strong source of growth, that will now strengthen world growth generally. With raw material capacity still large and overshadowing commodity markets, we see a long period of world expansion ahead. The main risk to the world economy is that central banks repeat the past mistakes of the 2000s in excessively loose monetary policy. Our hope is that progressive reversal of the financial regulation backlash following the financial crisis will allow interest rates to rise, central banks to sell off their huge portfolios of bonds, and so lead to a normal monetary environment that will permit moderate continued growth for a long time.

This improving international growth environment puts further strength behind my longstanding view that UK monetary policy needs to tighten in order both to get a grip on UK inflation and to start removing the distortions in the savings market. As usual I would like to see rising interest rates and the reversal of QE.

Vote by Peter Warburton

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

UK monetary policy is confronted by two powerful forces, global and domestic, that are pulling in opposite directions. The global pull is a positive dynamic, favouring the goods-producing and exporting sectors and regions. The domestic pull is a negative dynamic, focused on adverse consumer trends and weakened expectations. The domestic pressure on policymakers is increasingly to hold off from tightening measures, particularly ahead of the UK's planned departure from the EU. However, the global pressures all but guarantee that the structure of global interest rates – across the yield curve – should rise. UK Bank Rate is

caught up in the global interest rate narrative and the MPC has limited scope to resist what is a long overdue policy normalisation. Clearly, domestic consumers will not welcome interest rate increases, especially if real employment incomes fail to revive.

Since the summer of 2015, despite a tightening labour market (until quite recently) and a resilient industrial economy, the UK consumer outlook has continued to sour. The confident expectation of market-friendly, lower-tax economic policies has given way to a cautious truce with populist tendencies and a material background risk of massive regime change under Jeremy Corbyn. A weakened government has appeared to shift its ground significantly in the first round of Brexit negotiations and the notion of paying for access to the European Single Market appears to be under serious consideration. At any stage, Sterling's hard-won gains could be surrendered, triggering a second round of currency-related shocks.

Although the UK economy is languishing in the shadows of the global economy's Indian summer, interest rates are nudging higher and the noose is tightening for those with poor credit scores and weak balance sheets. The zombies – businesses and households – are being rounded up and shot in ever larger numbers. Begbies reported a 36 per cent uplift from a year earlier in businesses experiencing significant financial distress in the final quarter of 2017. Layoffs have become more numerous and aggregate hours worked appear to have levelled out, even though headcount employment is still rising.

I have looked hard for catalysts of improvement in UK household finances this coming year. The hoped-for wage acceleration remains plausible, but elusive. Consumer mortgage and credit trends are softening and fixed rate mortgage costs are drifting higher. Global inflation is heading higher in 2018, offsetting the abatement in UK-specific currency-related inflation. Self-employment incomes are stalling after a strong run. There is a need to break the deadlock and to inject a new dynamism into household income expectations. Ahead of the completion of the Brexit negotiations, for good or ill, it is difficult to identify a credible boost to business and consumer confidence.

UK monetary trends remain subdued, but not unduly worrying. Broad money and broad lending growth rates in the region of 4%-5% per annum should not set off alarm bells. Despite, rumblings of consumer discontent, it is time to get on with the first stage of rate normalisation, towards a Bank Rate of 1.5%.

Vote & comment by Julian Jessop

(Chief Economist, IEA)
Vote: Raise ¼%.
Bias: To tighten.

The UK economy has continued to grow at a steady pace, despite Brexit uncertainty, helped by the strong global upswing. In the meantime, inflation remains well above target. The Bank should therefore continue the process of returning interest rates towards more normal and sustainable levels.

Vote and comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: raise rates ¼%.
Bias: None. Time to start unwinding QE and end its distortions.

Without the slowdown in UK economic growth to around 1½%, price inflation might have become an issue. But it has, and it is not. Updated forecasts for UK GDP in the spring economic statement from the Chancellor showed the worst 5-year path for economic growth in decades. Not surprisingly, consumer price inflation is projected to hit the 2% target by the second quarter 2020, albeit with an assumption of two more ¼ point rate rises. However, with price inflation falling to 2.7% in the year to February price inflation could decelerate to 2% before the end of the year.

Wage inflation may or may not accelerate – the jury is still out but seems unlikely based on a slowing economy and profit margin pressure on consumer-facing firms. With a slowing economy and signs that unemployment is edging up, annual growth in consumer credit is slowing fast. It seems unlikely in this environment that wage inflation will accelerate.

Borrowing growth of small and medium-sized firms is easing and was zero on an annual basis in January 2018. Deposits from the sector seem to be under pressure. At the aggregate level, however, 3-month annualised M4 growth ex-intermediate financial firms of around 5% is still consistent with the forecast rates of economic expansion this year. But the bias of the recent data flow seems to suggest that two or more rate rises this year is not a done deal.

Policy response

1. All nine members voted to raise the Bank rate by ¼%.

2. Eight had a bias to raise rates. One had a neutral bias.

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. 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 currently 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).