Shadow Monetary Policy Committee

17th April 2018

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Shadow Monetary Policy Committee votes eight to one to raise Bank Rate in May.

Ending six months of unanimity for rate hikes, the Shadow Monetary Policy Committee (SMPC) voted at its April meeting to raise Bank rate in May by eight votes to one. Six of the nine wanted to see a rise of ¼%, two an increase of ½% and one a hold. Seven members had a bias to tighten, and two had a neutral bias. Of the nine, two wanted to see QE start to be reversed as soon as possible. Financial market signals about the pricing of risk and investor sentiment were being lost owing to the central bank's significant share of the UK's fixed income market.

The eight that wanted to see higher interest did so in spite of agreeing that the pace of global economic growth was slowing and that inflation pressure was easing in the UK. But they felt that the UK economy's growth rate and its positive, albeit slower, trajectory justified further rate hikes on a number of grounds. One was that rates had been too low for too long with adverse economic effects. A second was that, though easing, price inflation remained above target and lower inflation was giving real consumer incomes a boost. Third, that the drag from Brexit uncertainty was fading and that the economy would consequently benefit over the next few months. Finally, efforts to return to interest rate normality must be maintained as lower rates will be required if the economy falters in future and for that to happen, they need to be higher in the short term.

The sole dissenter felt that the MPC's February Inflation Report target for consumer price inflation in Q1 has been undershot and that its economic growth projections for the quarter were too optimistic. With inflation easing and the economy slowing sharply there was little to justify a rate rise at this time. Indeed, a rate rise could damage the economy for little gain.

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 17 April 2018

Attendance: Jamie Dannhauser, Kent Matthews (Secretary), Peter Warburton and Trevor Williams (Chairman).

Apologies: Tim Congdon, John Greenwood, Graeme Leach, Andrew Lilico, and Patrick Minford.

Chairman's comments: Trevor Williams welcomed everyone to the meeting, noted the apologies and invited Jamie Dannhauser to present the international and monetary background.

The global backdrop

Growth momentum in Eurozone has softened...

Jamie Dannhauser said that global growth remains strong. The second half of last year had all the indicators showing strong growth but the first quarter of 2018 has shown a softening particularly in Europe. He said that while growth momentum in Europe has dissipated, the Q1 figure for emerging economies particularly China is an upside surprise that will maintain the robust dynamics of last year and will carry through into the current year. Now-casting suggests that the momentum in Europe has softened. He said that in his view, the data overstated the pace of growth last year and it is now overstating the pace of slow-down. The USA is likely to be impacted by a strong fiscal boost, with spending being more material than tax cuts. Weather factors might explain some of the Q1 slowdown, but his view was that growth has been above trend in the last four quarters and subject to noise factors, survey indicators show that the economic momentum in the USA is still material.

…but Q1 upside surprises from China in particular.

He said that now-casts are pointing to a slowing, but his bias is that economic data was overly strong and is now rolling over from an above-trend growth position in the past year. Along with the US fiscal impulse, money and credit indicators are not pointing to a downturn. Based on his indicator of wage growth, the USA inflation pressure looks more material. Financial conditions have tightened in the US but only marginally. The big picture is that while short rates have been raised in the USA, this has not been translated into long rates.

…US inflation pressure appears material.

Peter Warburton asked for Jamie Dannhauser's thoughts on the inventory cycle in the USA. There has been a period of lean inventory building and if there is likely to be a stronger inventory build-up in the near future. Jamie Dannhauser said that many of the surveys he has seen the point to a build-up of inventories, which provide an additional fillip to GDP growth in the USA. Another country with an upside scope for inventory build-up is the UK where firms have responded to Brexit through reduced inventories. However, the likely build up of inventories could also add to UK GDP growth.

UK money and credit conditions

Broad money growth weakened…

Broad money growth in the UK has slowed aggressively. If one wanted to construct a narrative around the money numbers alone, then the picture looks concerning for nominal demand growth. Part of the story is banks choosing to issue more debt relative to money on the balance sheet as part of a balance sheet management adjustment. It is hard to make a case that credit growth is accelerating. Bank lending growth is rolling over, again partly reflecting increased bond issuance by companies. There is also quite a lot of foreign currency borrowing by companies.

Furthermore, survey data suggests that the overall cost of bank funding is rising. The reason given is that risk-free rates have risen, and global swap rates have risen. The survey also suggests that bank capital is being drawn down as regulatory pressure has abated. But at the same time, bank credit supply is tightening. Kent Matthews questioned how regulatory pressure and capital draw-

down could coincide with tightening credit conditions. Jamie Dannhauser said that there were a number factors working and one is the change in bank's risk appetite which is diminishing after having risen to very high levels. Certainly, with consumer credit, it is still regulatory driven by the FPC. But it is not obvious what the main driver of tightening credit is overall. Generally, the cycle of loosening credit conditions in the UK is now over. This is also seen in the CBI survey with firms reporting tighter credit access.

…data consistent with a weakening of nominal demand

If you wanted to construct a story based on a weakening of the nominal side of the economy that is pessimistic on growth and low concern for inflation pressure, then the money and credit data provides such a picture.

Now-casts of the UK economy suggest that momentum was lost in Q1. Additionally, the housing market has been very weak. The London market is exceptionally thin. Trevor Williams said estate agency surveys have seen volumes fall by 10-20% and that sellers have been taking houses off the market waiting for prices to rise. Jamie Dannhauser added that the measure of house price rises based on actual transactions is not informative if there are only a few transactions occurring. He said, however, that there is a reason to believe that real GDP growth in 2018 will be in the region of 1.5%-with risks to the upside and that he was still concerned about upside inflation risks.

Reasons to be less pessimistic.

However, there are reasons to be less pessimistic about the UK economy. He said that firstly import costs have fallen as the depreciation effect has been completed. Second, consumer sentiment is less pessimistic and has held up even with squeezed real income and higher inflation over earnings. Third, labour demand remains solid, and vacancies are holding up. It is hard to make the case that Brexit has resulted in employers cutting back on employment. Peter Warburton said that momentum has failed on total hours worked. Jamie Dannhauser agreed that average hours worked has fallen particularly in the financial sector and that has implications for the average earnings figures. Fourth, despite the upward rise in sterling in recent months, survey data suggest that exports have been doing well. Finally, despite all the narrative on Brexit, CAPX has held up well. The CBI survey is saying that there has been a slight slowing in CAPX intentions but nothing as bad as official data. It raises the possibility that official data is understating CAPX. He said that while he did not want to give the impression that the UK economy was growing strongly, he felt that there was reason to challenge the pessimistic scenarios and that UK growth would be in the 1.5%-2.0% region in 2018.

Headline inflation falling but core inflation still at 2.5%

Regarding inflation, Jamie Dannhauser said that UK headline inflation has peaked, but core inflation is at about 2.5% The concern is whether inflation will continue to fall towards 2% or if there is some underlying pricing pressure remaining in the system. As part of this driver, Jamie Dannhauser said that he was impressed by the slump in rental inflation which measures actual rents paid by tenants – both social and private sector rents. The effect of sterling on inflation is at its apex. The effect of the fall in sterling on high import intensity products has stopped rising.

A broad measure of unemployment which includes part-time workers wanting full-time work and inactive labour looking for work shows that unemployment has continued to fall. The argument that there is spare labour capacity does not hold up. Survey measures of the output gap suggest that spare capacity is long gone.

Labour market concerns

ONS figures show that pay growth is picking up. Average weekly pay has been held down by the decline in average hours worked. But underlying earnings are rising, and inflationary pressures are building up. At the margins of the labour market, there will be stronger evidence of a 'Phillip curve' effect. Wage growth for people who have remained in their job compared with people who have moved jobs has increased markedly. Marginal pay pressures are greater than the average. The average earnings figures are held down by those who have not moved, but as workers move jobs, the cost of the marginal worker is rising rapidly,

which will eventually impinge on the average figures. For these reasons, he said that inflationary pressure is worrying.

The Chairman thanked Jamie for his commentary and then invited comment.

Comment

Financial market bubbles and bond markets

Kent Matthews said that the marginal pay differential conflates relative wage adjustments associated with re-skilling and scarcity with general inflationary pressure. Trevor Williams added that marginal pay movements might reflect differences in productivity growth where higher productivity jobs pay for themselves, and therefore may not be inflationary. Peter Warburton added that the household earnings and employee earnings have diverged over time. The so-called 'lost decade' for real median after-tax earnings is misleading as the share of employee earnings in household incomes has dropped to about 60%. Increased employment levels and stronger growth of households' other income sources paints a brighter picture of the past decade. Median employee earnings have been depressed by the influx of lower-paid migrant labour.

The Chairman called the discussion to a close, he thanked Jamie Dannhauser for his presentation and said that he had a few votes in absentia. Andrew Lilico who was meant to Chair the meeting sent his apologies as he was tied up at a meeting at work. He said that he would hand over to Andrew Lilico electronically. He then invited the attending members of the Committee to offer their votes and comment.

Votes are recorded in the order they were given

Comment by Peter Warburton

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

Peter Warburton said that while he agreed with a large part of Jamie Dannhauser's presentation, he said that he was little more sceptical about where growth was going to come from. The continuance of fiscal tightening as set out in the Spring Statement was taking some risks particularly as the consumer sector is weakening this year. He said that he was noticing a loss of momentum in the distribution, hotel and restaurant sectors. Fiscal restraint may be overdoing it: rolling changes to the benefit system and incremental recoveries of old tax liabilities by HMRC. Post-tax real incomes are still under strain. However, the softness of the consumer outlook should not be a guiding principle for the MPC. We are well behind the curve, and he believes that the MPC's aim should be to raise Bank Rate to 1.5% over the next 12 months. He said that his vote is a double raise (0.5% in May) and a bias to raise.

Comment by Jamie Dannhauser

(Ruffer LLP)
Vote: Raise Bank Rate by ¼%.
Bias: To increase rates in stages.

Jamie Dannhauser said that he would like to see a rise of 25 bps and would be keen to actively signal the need for further tightening. The structure of interest rates is ridiculously flat. Market expectations of bank rate five years out at 1.3 per cent should be higher. He said that he had said that the August 2016 stimulus package was unnecessary and also counterproductive. However, despite a not too bright outlook for growth, he said that there is more of an inflation bias in the

economy than there has been for a long time. The Bank had encouraged a cost shock when the economy was close to full-employment and now the economy above full-employment. He said that at this late stage the Bank is unable to do anything about inflation that is already in the pipeline.

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 if the argument for raising rates included the signalling point about the future path of rates, he felt that there was a strong argument for a rise of 50bps. Simply reversing the cut in rates last November to where we were in the pre-Brexit vote was an insufficient signal. He said that he had consistently voted for a rise in rates of half per cent for some time and as a signal, such a move would have a stronger impact than the 25bps movements the market has got used to.

A 50bps rise would not be what the market expects and the effect on sterling would be that much stronger and pushing down on any latent inflationary pressure. 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 Trevor Williams

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

Trevor Williams said that while he was still, just, sticking to a quarter-point rise in bank rate, he increasingly thinks the moment to have raised is now gone. He said that he was increasingly concerned about the economy and what the monetary statistics are signalling about the direction of economic activity. It is not just that the Financial Policy Committee (FPC) is tightening credit conditions and that this is leading to a slowdown in lending but that people's ability to borrow has been eroded because pay conditions remain tight for those who have not changed jobs. He said that he was not convinced that unemployment levels could stay at current levels given the easing in the pace of growth and that inflation concerns were unwarranted.

In any analysis of financial market data, there is a need to take into account the huge amount of QE that has distorted these markets and which needs to start at least to be unwound to uncover their true values. In short, tight money market spreads and relatively calm in asset markets may be as much a symptom of central bank activity than anything else. We need to find out before raising rates too far, and this can only be done by withdrawing some of the QE. Undoing this in his view before the serious business of interest rate normalisation gets underway means at the very least that the Bank needs to stop re-investing proceeds from maturing bonds and begin to unwind QE. By doing this, the Bank of England will signal to financial markets a tightening of monetary conditions and let the market find its 'own' level, without unduly impacting households. He also said that Brexit uncertainty is adding to the general scenario of policy uncertainty.

Comment by Graeme Leach (in absentia)

(Macronomics)
Vote: No change to Base Rate.
Bias: Neutral.

With February headline CPI at 2.5% (yr-on-yr) and core CPI at 2.3% (yr-on-yr), inflation is undershooting MPC expectations for the first quarter of 2018. Obviously the MPC's view on inflation extends out over a 2-year horizon and is not formed on the basis of current figures alone, but the latest inflation figures provide comfort if the MPC were to choose, contrary to general expectations, not to increase the base rate in May.

CPI inflation is not the only reason for the MPC to hold back on a rate rise in May. Other dampening influences include the increase in both employer and employee auto enrolment rates in April, which is likely to take some of the edge off retail sales and consumer spending. In addition, asset prices have moderated significantly. UK house price growth is around 5% (yr-on-yr), with the FTSE100 down 8.5% on its level at the end of 2017.

Throw in the relative strength of the pound recently (albeit slipping slightly after the inflation announcement) and its effect on import prices, and the MPC will have just reason to hit the pause button. One interesting outcome from the latest inflation figures is that real wage growth has accelerated (2.8% earnings growth minus 2.5% inflation), but the scale of this acceleration does not make the case for a rate rise now.

Finally, UK and global monetary growth is signalling a weakening, not a strengthening in nominal GDP. UK M4X broad money growth slipped to 4.5% (yr-on-yr) in February from 5.1% (yr-on-yr) in January. Euro-zone M3 broad money supply growth eased to 4.2% (yr-on-yr) in February from 4.5% (yr-on-yr) in January. Japanese M2 money supply growth was down slightly to 3.3% (yr-on-yr) in February from 3.4% (yr-on-yr) in January. And in the United States, M3 broad money supply (produced by Shadowstats) trundles along at around 5% (yr-on-yr), and as yet doesn't suggest a sharp pick-up in US nominal GDP growth.

Indeed, narrow measures of global money supply (such as real narrow money for the G7 advanced and E7 emerging economies) are signalling warning signs, with the rate of growth of this measure at a nine-year low.

Comment by Julian Jessop (in absentia)

(Institute of Economic Affairs)
Vote: raise rates ¼%.
Bias: To tighten.

The big picture is still that the economy no longer needs emergency support from monetary policy, especially with unemployment at multi-decade lows. Indeed, another small step towards a more normal and sustainable level of interest rates should actually help the recovery. Some of the recent UK data has been a little softer than expected and the global economy appears to be slowing.

But the headwinds from the Brexit vote are also fading, as inflation falls back and business confidence is boosted by the preliminary deal on a transition period.

Vote by Andrew Lilico (in absentia)

(Europe Economics)
Vote: Raise ¼%.
Bias: to Raise by ¼% each month until rates reach 2%.

Previous comments still relevant: that the economy has withstood the last rate rise well and further hikes are still necessary.

Vote by Patrick Minford (in absentia)

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate ¼% and modest reversal of QE
Bias to raise

Previous position still stand.

Comment by Phillip Booth (in absentia)

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

Given the slowdown in monetary growth, though I still believe that a move to normalise interest rates is justified, it makes sense to move more cautiously than I have hitherto suggested. I therefore propose a rise of 0.25% with a bias towards further rises.

Any other business

None

Policy response

1. On a vote of eight to one, the committee agreed to raise the Base rate.

2. Six members voted to raise the Base rate by 25bps. Two voted to raise by 50bps

3. One member voted to hold rates.

4. By convention, there is, therefore, a decision to raise rates by 25bps

Date of next meeting

17 July 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 (Ruffer LLP), 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 (University of Manchester), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School).