Shadow Monetary Policy Committee

Meeting of 16th April 2019

For immediate release

Shadow Monetary Policy Committee votes Five / Four to Hold Bank Rate

At its second full meeting of 2019, held in April, the Shadow Monetary Policy Committee (SMPC) voted by a narrow margin to keep Bank rate at 0.75%. Five voted to hold rates and four voted for a ¼ point rise.

Four main reasons were given by those voting to keep rates at 0.75%. First, raising rates was not appropriate amidst the UK and global economic slowdown. Second, continued Brexit uncertainty, which was holding back business investment and that could now persist until the Autumn with the six-month extension to the leave date. Third, weak and below target consumer price inflation. Fourth, growth in broad money supply M4 easing to its lowest annual rate since 2011, when the economy expanded by 1%.

Arguments for a rate hike were partly based around the continued better-than-expected performance of the UK economy. Despite Brexit uncertainty, the economy was likely to grow faster than Germany and France this year. This prompted some members to switch their vote from a hold to a rise.

Additionally, for some, real rates were unhelpfully negative, and nominal UK rates were too low, even accounting for the stage of the economic cycle and the rate of inflation. The persistence of such low-interest rates was damaging to the supply side of the UK economy and, as rate rises in the US showed, rate rises can take place without wrecking the economy.

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 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.

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

Minutes of the meeting of 16th April 2019

Attendance: Phillip Booth, Juan Castaneda, John Greenwood, Julian Jessop, Andrew Lilico (Chairman), Kent Matthews (Secretary), Peter Warburton, Trevor Williams.

Apologies: Tim Congdon, Patrick Minford.

Chairman's comments: Andrew Lilico passed on the Chairmanship to Trevor Williams but agreed to chair the meeting today as Trevor was presenting the economic report. He officially declared the meeting open, and invited Trevor to provide the economic background.

The Global Economy Backdrop

Slowing global money growth…but no recession and no inflationary constraints

Trevor Williams began with the global monetary backdrop. Global M4 growth indicated an economic slowdown was underway, with low world price inflation, but no recession. Starting with the OECD figures for world M3, he said that there had been a sharp slowing in monetary growth in 2017 but this had settled at a new lower equilibrium in the past six months. Within the OECD, broad money in Japan has slowed, has shown signs of rising again in the Euro area in recent months. Similarly, broad money growth in the USA had decelerated sharply in 2017 but flattened off in late 2018. The consequence is that GDP growth in the USA will likely slow sharply late this year and next year, possibly dropping by one percentage point from the 2¾% recorded in 2018. India and China are exceptions, with India showing a sharp acceleration in M3 the last year and China, where money growth had been slowing, has seen an uptick in recent months. The global implication is that inflation should not pose a problem for monetary policy.

He said that IMF forecasts for growth are consistent with the monetary data and projected a cyclical downturn. Figures show the global slowdown is being led by industrial and manufacturing output, amidst a cyclical downturn in world trade. Unusually, consumer confidence is holding up well, backed up by record employment and rising real wages, assisted by weak price inflation. Global price inflation, including core inflation, remains low around the world and does not pose an issue for monetary policy.

John Greenwood said that the money supply growth in Japan is not going to slow growth there significantly, but it will slow down inflation. He said that the recent experience had destroyed two erroneous theories of inflation. First, the fiscal theory of inflation, and second the 'Phillips curve'. The first theory says that loose fiscal policy would generate inflation and the second says that tight labour markets will generate inflation. He said that Trevor's charts illustrate why inflation is low and that is because money growth is low.

But CPI inflation is lower than GDP deflator inflation

Peter Warburton said that he wished to push back against some of that. He said that what is true of CPI inflation is not true of GDP deflator inflation. He said a lot of CPI inflation is picking up the deflation in the prices of traded goods and there has not been an appreciable fall in GDP deflator inflation. He said that it was far too soon to conclude that a cyclical downturn in inflation has occurred. Trevor said that nevertheless policymakers were likely to focus on the fact that core inflation is on a flat trajectory in the developed economies and on falling trend in the emerging and developing economies.

UK economy

Large firms borrowing but SMEs are repaying debt

On the UK, Trevor Williams first pointed to broad money. He said that UK M4 growth is slowing rapidly to its 2011 pace, as is economic growth, but borrowing has accelerated in recent months. The data are showing that large firms are borrowing but SMEs are not and, indeed, have been repaying bank debt. Kent Matthews asked if the figures are saying that SMEs are not borrowing because they don't have access to bank funding sources and are turning elsewhere. Trevor Williams said that he did not think so. He said it was more to do with lower profits, particularly in the retail sector (as shown by defaults), and weaker prospects for demand, rather than access to funding, as reasons.

Brexit preparation strategy

Large firms are not only borrowing from banks but also through the capital markets. Andrew Lilico said that the figures are showing an increase in short-term borrowing through loans and commercial paper consistent with a Brexit preparation strategy. Trevor Williams said it may be stock building as preparation for Brexit, and other additional business costs such as hedging, opening representative offices in the EU etc. Andrew Lilico asked that because it is short-term borrowing, could there be a sharp repayment in the immediate future. Trevor Williams said that he thought there was some evidence of that already, as large firms were borrowing significantly less from banks compared with early 2018, and in some recent months had repaid loans.

Consumer borrowing doing well

He said that consumer borrowing is growing at high single-digit rates but that it was slowing pace, from around 10% pa a year ago to 6% this year. Why is consumer borrowing still doing well? Trevor Williams said that it was the underlying strength of the economy which, although it had slowed, remained resilient. Unemployment has fallen to 3.9%, price inflation has dropped below target, and real pay has therefore picked up. Expectations of interest rate rises based on surveys have fallen. He said that therefore it was not surprising that retail sales spending growth continued on the upside. However, household confidence has dropped back, which is reflected in a slowdown of household spending.

Trevor Williams said that business investment has been sluggish for some years, even before the EU referendum, which also dovetails with the poor productivity record of the economy. Andrew Lilico said that once uncertainty is removed, there is a possibility of a surge in investment. Trevor Williams said that inward investment has been strong because of the cheapness of sterling. He said that the Bank of England data was showing UK firms borrowing to prepare for Brexit by contingency planning and hedging action.

Trevor Williams added that UK balance sheets have deteriorated, with all the domestic sectors being net borrowers. Therefore, the UK was net borrowing abroad. He said that households have reduced savings to maintain spending but that their net asset position remains strong. He said that with regard to UK banks, the funding gap has narrowed (indeed, UK banks held a small excess of customer deposits over customer loans) and wholesale funding has declined. John Greenwood said that bank lending is much more aligned with customer deposits rather than recourse to money market sources.

The economy is on a cyclical downturn in concert with the rest of the world

In conclusion, Trevor Williams predicted that the economy would grow at 1-1.5% over the year, consistent with estimates of low underlying productivity growth but the expansion of the working population. He said that the policy implication is that there was no need to panic and that rates should stay on hold. The economy is on a cyclical slowdown as is the rest of the world and nothing much can be done about it. Low inflation and a tightening labour market is sufficient to keep the economy growing at 1-1.5%.

Comment

Manufacturing slowdown..
..automotive sector adjustment

Juan Castaneda asked for clarification about the slowdown being led by manufacturing. Trevor Williams said that this was a global manufacturing based downturn due to slowing trade in goods worldwide, amidst a technology switch in the automotive sector (away from diesel and petrol to electric). Services – where technology was driving up demand - and its expenditure equivalent, consumer spending - were doing much better. Philip Booth said that the manufacturing slowdown is possibly an adjustment in the automative sector. Julian Jessop noted that in terms of employment, the car sector is quite small.

Andrew Lilico questioned what the appropriate monetary response should be to a technical transition in an individual sector. Should rates be lowered to ease the transition process? Phillip Booth said that the fall in demand for diesel vehicles had not been replaced by an increase in demand for petrol cars and that consumers may simply be postponing purchases of cars as they await further innovation in the electric vehicle sector. Any adjustment would have imperceptible effects on the equilibrium real rate of interest. Andrew Lilico continued to ask if the technological shift appeared as a terms of trade effect should there be a temporary adjustment to monetary policy? There was general agreement by members of the committee that monetary policy should not be dictated by sectoral shifts. Trevor Williams said that policy in such circumstances should be focussed on local fiscal policy, retraining, and infrastructure.

Andrew Lilico invited those present to make their votes.

Votes are recorded in order they were given

Comment by Phillip Booth

(St Mary's University)
Vote: Hold
Bias: No bias.

Phillip Booth said that this was a time to do nothing and voted for no change in rates with a bias for no change. He said that there was a danger of micro management of monetary policy which would be inappropriate.

Comment by Julian Jessop

(Independent Economist)
Vote: To raise by ¼%
Bias: To raise.

Julian Jessop said that his starting point is that interest rates are currently unhelpfully low and that he thought that they should continue to return towards more sustainable levels at the earliest opportunity. He said that the reason he voted for a hold last time was because of the Brexit uncertainty. But with the increasing likelihood of 'Brexit in name only', much of the associated uncertainty has evaporated. He said that another small change in rates from these low levels would not be likely to derail broad money growth or the real economy.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To raise by ¼%
Bias: To raise.

Peter Warburton said that the Bank of England has been distracted by Brexit and unnecessarily been involved in the Brexit debate. He said that there was a latent adjustment to policy that was needed that was non-cyclical and non-conjunctural. He said the he would like to see rates 50-100 bps higher within 12 months. He said that the policy rate was unhelpfully low. Rates have risen in the USA without the economy falling apart. He did not see a debt distress reason for not raising rates. He said there was plenty of scope on the nominal side and even the real side of the economy for interest rates to rise.

Comment by Juan Castaneda

(Institute of International Monetary Research and University of Buckingham)
Vote: To Hold
Bias: No bias.

Juan Castaneda said that he appreciated the discussion about the extraordinarily low level of nominal interest rates. But he could not support a rise in rates in the current monetary environment. All the forecasts are for inflation to remain in the region of 2%. As broad money growth (M4x) has been decelerating in recent months (growing at only 2% annually according to the latest, February 2019, data), he said that there are no inflationary pressures in the medium term, so why change interest rates?

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise by ¼%.
Bias: To Raise.

Andrew Lilico said that he felt that the Bank of England would have raised interest rates at least two times in the past year to 18 months if not for Brexit worries. If Brexit remains an excuse, then interest rates would remain on hold for years to come. We should raise rates to catch up where we would have been if not for the uncertainty arguments of Brexit and also because low rates are not conducive to growth. He said that raising rates would not be bump free, but the experience of the USA is positive. He said that his one concession to the money growth figures is that he would not recommend a reversal of QE.

Comment by John Greenwood

(Invesco Asset Management)
Vote: To Hold.
Bias: Neutral.

The low rates of money growth have partly been the result of cautiousness on the part of the banks, and partly a reluctance to borrow by some customers. Brexit or no Brexit, inflation will fall to below 2 per cent and therefore there is no reason to raise rates now. He said that there will be plenty of time to judge when bank lending and money growth rises, and inflation be a problem in the future. He voted for rates to remain at 0.75% with no bias.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To raise by ¼%
Bias: To raise.

Kent Matthews said that there was a disconnect between the official bank rate and the rate of interest faced by small businesses if they could get bank credit. He said that this disconnect was a symptom of a broken financial system that was failing to allocate financial resources from weak and failing enterprises to potentially strong enterprises. He said that there is a fundamental allocative inefficiency in the banking system and that the economy needed to get back to an equilibrium where funds can flow away from low-productive sectors to emerging high productive sectors. These are microeconomic issues and that given that Brexit uncertainty had dissipated, and the economy was not expected to tank, it provided the opportunity to return interest rates to some form of normality where real rates were positive. He voted to raise rates with a bias to raise further.

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Comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: Hold.
Bias: No bias.

Trevor Williams said that if not for the money supply figures he would be on the side of raising rates. He said that he was worried about the continuance of negative real rates of interest, and the unhealthy economic impact of the permanence of such rates. However, on balance he said that he had made his views clear in his commentary and as such that he would vote for a no change in rates with no bias.

Comment by Graeme Leach (in absentia)

(Macronomics)
Vote: To Hold
Bias: No bias.

M4X broad money supply growth stands at 2 percent (year-on-year). This is the lowest rate of growth since 2011 and provides no grounds for tightening monetary policy, when considered alongside the fact that CPI inflation is below target at 1.9 percent and Brexit uncertainty abounds. Against this background no change in interest rates or QE seems sensible. In the unlikely event that a no deal Brexit were to happen, and the UK finally leaves the EU, there could be a surprising bounce-back in economic activity in the second half of 2019. However, there is also a considerable risk of the political chaos at present risking an extreme left wing Corbyn Government, that would alarm financial markets. Amidst all the Brexit discussion it has been forgotten that the Leader of the Opposition and his Shadow Chancellor advocate the overthrow of capitalism. These are dangerous times.

Any other business

None

Policy response

1. On a 5 to 4 vote the Committee voted to keep rates on hold.

2. The physical meeting was evenly divided between four votes to raise rates by 25 bps and four votes to keep rates on hold.

3. The ninth vote in absentia gave the decision to hold rates at 0.75 per cent.

4. The closeness of the votes indicated the closeness of the decision.

5. There was no consensus as to bias in future policy. Four members retained the bias to raise rates while the rest indicated no bias.

Date of next meeting

16th July 2019.

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 of 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.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Rotating Chairman is Andrew Lilico (Europe Economics) and 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 (Institute of International Monetary Research), Jamie Dannhauser (Ruffers), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Julian Jessop (Independent Economist), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Manchester University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School), Juan Castaneda (Institute of International Monetary Research and University of Buckingham).