Shadow Monetary Policy Committee

16th SEPTEMBER 2019

Embargo: Not for publication before 00:01am Sunday 15th September

An email poll of members of the Shadow Monetary Policy Committee (SMPC) carried out in late August, and early September 2019 resulted in a vote to keep interest rates on hold by six to three, the same margin as in July.

Three dissenters wanted to raise rates by ¼% immediately and then gradually to around 1½%. Six members voted to keep Bank rate at 0.75%. In terms of the bias to the policy stance, five members were for further tightening, three were neutral and one for loosening.

Slower UK and global growth, continuing Brexit uncertainty and the prospects of a no-deal EU exit prompted six members to vote for a hold. Worries about the immediate disruptive impact on demand and supply in an economy already contracting were cited as factors in the decision to hold rates. Fears of a further fall in output in Q3 and continuing slow expansion in broad money were also influential.

Three members thought that monetary policy needed to be tightened to help restore its effectiveness as a policy tool. The buoyant UK labour market and the resilience of consumer spending were signs that the economy could withstand a tighter stance. One thought that fiscal expansion was required to mop up excessive savings. Such an action would help to drive up rates and help restore monetary policy to a position where it could act as a counterweight to fiscal policy - and regain its effectiveness - in investment decisions.

All agreed that these were extraordinary times and that the aftershocks from the last crisis still reverberate as does the policy reaction to it.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997, with a briefer email 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 regularly gathers 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.

For Further Information on the Content Please Contact:

Trevor Williams + 44 (0) 7841 497791 trevor@trevorfwilliams.website
Andrew Lilico + 44 (0) 207 269 2644 andrew.lilico@europe-economics.com

Emma Revell 07941 698246 erevell@iea.org.uk

Votes

Vote by Phillip Booth

(St Mary University, Twickenham)
Vote: Hold
Bias: No bias.

Vote and comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)
Vote: Hold
Bias: To ease by restarting QE.

My position is no change in bank rate or QE, but with a bias to ease, probably by restarting QE if money growth remains weak and the world economy deteriorates (which I don't expect as a central case).

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise by ¼%
Bias: to raise and no change in QE

Vote by Julian Jessop

(Independent economist)
Vote: Hold
Bias: To tighten.

Vote by Graeme Leach

(Macronomics)
Vote: To Hold
Bias: Neutral.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Hold.
Bias: To tighten.

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 policy challenge with monetary policy a busted flush

It is no wonder that Andrew Bailey has been making speeches about the need for continued Bank independence. Monetary policy has failed comprehensively both here and around the world.

Look at the record. First in the noughties western central banks allowed a big credit boom. Then when it predictably hit the buffers of resource constraints and caused big bank losses, instead of injecting enough liquidity into the banks to make sure of their survival, they feebly - and apparently under political pressure- allowed Lehman to go under, and so caused the Financial Crisis. Then, just when they needed to get banks up on their feet, lending strongly for the recovery, they hit banks with a huge regulative whammy, requiring big rises in expensive equity capital. The recovery and credit growth duly stalled and the deflationary treat took over, with interest rates down to zero. Since then central banks have twisted and turned, rolling out QE, which has made it an easy financial world for governments and big companies, and a tough world for SMEs (loans to them force extra high capital needs) and savers. The result has been weak growth and rising monopoly power, with falling productivity growth.

It is a terrible mess and a dreadful record. Why indeed trust central banks after this? They have brought popular discontent and frustration onto the capitalist system, piling pressure on politicians who favour free markets to keep out the socialist Corbyns and Warrens of this world.

How to get out of this mess? With monetary policy powerless until interest rates get back up to normal levels where world savings do not dwarf world investment, we need a period where fiscal policy is highly expansionary, to shift the world balance back towards a savings shortage and drive up rates. Fortunately, this is the approach both of Trump and Johnson; so, both the US and the UK are now embarking on sizeable deficits, with 'austerity' well buried. Unfortunately, the EU is gripped by German fiscal orthodoxy- macroeconomics is barely understood by German politicians, and where they do get some glimmerings, regarded as the work of the devil, and specially designed to transfer German money to foreigners. So, the chances of fiscal expansion in the EU are nil. In Japan too, policy is inert - monetary policy powerless as here and fiscal policy hamstrung by a huge public debt/GDP ratio of 245%; as it is almost entirely domestically held by Japanese households happy to hold money and saving heavily due to ageing, this is not a problem, but the Abe government sees it as one.

So as so often, the world now depends on the Anglo-Saxons: this time pulling it out of the zero interest world with fiscal activism, so that monetary policy can rise from the ashes.

When this happens, there will need to be new leadership at central banks; and it will have to be in tune with popular opinion, after this terrible crisis debacle. It must be very doubtful that they will keep their independence. With so little demonstrated competence, why do they deserve to?

Whoever leads them, central banks will need to follow monetary rules that are guaranteed to stop future crises. We have done research on these rules. We think a highly effective one would both stabilise prices at some steady level and also react strongly to demand shocks, aiming to keep output close to some steady growth path. In this new policy world interest rates would need to vary aggressively in response to boom and slump, much as they did over the long runs of history before the unusually quiet 1990s. With monetary policies like this, crises such as we have just had should be relegated to the footnotes of history, instead of dominating history as in the recent decade.

For now, monetary policy is an impotent irrelevance.

How to behave in this role? In anticipation of expansionary fiscal policy from this Conservative government determined to bury austerity, the Bank should dwell

on the tightening of the labour market, raise rates gradually and allow QE to reverse by first not replacing its bond holdings as they mature and then gradually liquidate its holdings. This tightening will encourage the government to pursue necessary fiscal expansion**.**

Vote and comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ¼%.
Bias: To raise Bank Rate in steps of ¼% to 1½% and announce a programme of £60bn bank of England gilt sales .

If the conduct of monetary policy was only about current and prospective demand conditions, then it is understandable that policy would tend to an easing bias. According to Eurostat, a comparable indicator of economic sentiment has fallen (since last August) by 2 points in France, 6 points in Italy, 12 points in Germany but 15 points in the UK. In terms of the index level, the UK sits second-last in the EU28 table, beating only Slovenia.

Labour productivity is falling; corporate profitability is declining; investment in equipment is falling in real terms and nominal GDP growth is a paltry 3.2 per cent, which becomes 2.6 per cent on a per capita basis despite a monetary policy stance that is as loose as cooked spaghetti. The rising household unsecured debt burden is of great concern. The post-referendum household saving ratio is around 4 per cent, which implies a negative discretionary saving rate once automated pension saving is excluded. Unsurprisingly, public expenditure is accelerating in mitigation of numerous contexts of crisis and the budget deficit is widening again. The financial and ancillary services sector is in recession again after a brief flurry in 2015-16, prior to the Brexit referendum. More broadly, the infrastructure is creaking – power outages and fried overhead railway cables – and the incidence of violent crime is rising alarmingly. Moreover, in the case of this patient, further medication (e.g. lower interest rates) would be futile and dangerous. The most promising treatment would appear to be shock therapy. Indeed, perhaps the best way to think of impending Brexit is as a defibrillator, designed to rouse the patient from stupor to consciousness and, ultimately, to restore a healthy rhythm.

Such a treatment is not without risk. Financial asset and currency price charts could look pretty scary in the immediate aftermath of the shock. One of many ironies is that the stabilisation of the post-Brexit economy will depend on the return of the overseas bid for UK business and financial assets. Rather than “taking back control” of the economy, there is a danger that Brexit will propel the trend towards foreign ownership of UK businesses. Another is that, far from recouping a post-Brexit dividend, the UK economy will depend on a significant fiscal boost over the next couple of years, returning the budget deficit to 3 per cent of GDP this year and quite possibly 5 per cent of GDP by 2021-22.

This sea-change has begun. Tax revenue growth has weakened, despite the bullying tactics of HMRC, while public spending is booming again. More spending will be committed to No-Deal preparations, law and order, NHS, social care, replacement EU subsidies and appeasement payments to Scotland, Wales and Northern Ireland in a desperate bid to sustain the union. Who knows, this autumn’s Budget, may also contain some material personal income tax cuts, in a sop to the prime minister’s leadership campaign pledge.

The challenge for the Bank of England is to ignore the clamour for policy easing and to use the cover of dramatic fiscal relaxation to resume the normalisation of Bank Rate. Whole economy average weekly pay growth has lurched to 3.7 per cent and unit labour cost growth in the market economy is well above 3 per cent and plainly inconsistent with the official inflation target. Once the Bank takes off its Brexit blinkers, we can hope that it will reconnect with its original purpose. At

some critical point, Sterling will fully price the risks of chaotic disruption but will remain agnostic on the MPC's commitment to higher interest rates. Only at this point, will the risk-reward balance tip in favour of a material Sterling rally.

The wild card for the UK economy, is the net effect of Brexit's disruptive impact on the EU economy. The likelihood is that UK consumer spending, in real terms, will fall in 2020 with an amplified effect on the rest of EU exports to the UK. The Irish Republic and Netherlands will suffer disproportionately. There is a fanciful scenario in which the UK will receive capital flight from the European continent as the EU contends with economic recession, another banking crisis, US protectionism, Italian exceptionalism and Brexit all at the same time. The latest noises from Germany suggest that a large fiscal relaxation is in the works, dressed up as a climate change initiative. Whatever happens, the EU's Excessive Deficit Procedure is a dead letter.

I look forward to visiting the patient in the recovery ward with a strong and steady pulse. However, in the near term, expect the UK economy's vital signs to lurch around as supply chains prepare for 31st October and as investors realise that the UK is not going to be a paragon of fiscal virtue for quite some time. This is possibly the only confident prediction, given that a change of government would merely accelerate the loosening.

The Bank of England's Monetary Policy Committee should be emboldened by the resilience of the labour market and the consumer economy to press on with measured rate hikes. The next 3 quarter points should be executed mechanistically to return Bank Rate to 1.5 per cent. An announcement of the phased reversal of the QE programme, initially to withdraw the £60bn added in 2016, should be implemented as soon as possible.

Vote and comment by Trevor Williams

(University of Derby & TW consultancy)
Vote: Hold.
Bias: Neutral.

Brexit uncertainty and the risk of an imminent no-deal exit from the EU is too high at the moment to raise interest rates. World economic growth is slowing, and UK economic output dropped by 0.2% in Q2. A fall in the current quarter (Q3) is possible and hence a modest recession is also likely.

Adding the weakening global backdrop into this mix means that an easing in world price inflation is likely, resulting in lower UK inflation, even if the pound fell further from current levels. Meanwhile, the UK's monetary data are consistent with this prognosis of sub-trend growth and modest inflation risk in the medium term. As a result, monetary policy should be left as it is until the direction of the economy is clearer.

Policy response

1. Six members voted to hold Bank rate at 0.75%.

2. Three voted to raise by ¼%.

3. Five had a bias to raise rates. Three had a neutral bias. One had a bias to ease.

Date of next meeting

15th October 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 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.

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).