Shadow Monetary Policy Committee

15th October 2019

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Shadow Monetary Policy Committee votes Eight / One to Hold Bank Rate in November.

At its final meeting of 2019, the Shadow Monetary Policy Committee (SMPC) voted by eight votes to one to keep Bank rate at 0.75%.

Although the vote was held before Parliament decided to hold a General Election on 12 December 2019, none of the Committee members has changed their view. The adverse effects of uncertainty about a deal or not on leaving the EU remains the key issue driving the majority view on short term interest rates. All agreed that the economy had slowed over the last few months with uncertainty about Brexit cited as the critical reason.

Concerns do exist about the external environment, of trade wars, and slowing economic growth in the Eurozone. Still, the principal reason for the UK's weaker economy was felt by most to be Brexit uncertainty. There was general agreement that an end to that uncertainty might lead to a bounce in the pace of growth. At that point, some would vote for rate rises and QE to start to be reversed.

For the one dissenting vote to raise rates, the main factor was a view that monetary policy was already too loose and, even in the event of a further slowdown – whether due to a no-deal Brexit or not - further easing was not required. Indeed, rates should be raised immediately, and QE should start to be reversed to begin to undo some of the adverse effects on financial markets and investors.

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 15 October, 2019

Attendance: Roger Bootle, Andrew Lilico, Graeme Leach, Peter Warburton, Trevor Williams (Chair).

Apologies: Philip Booth**,** Juan Castaneda, Tim Congdon, John Greenwood, Julian Jessop, Kent Matthews, Patrick Minford.

Chairman's comments: Trevor Williams noted the apologies and invited Andrew Lilico to present the economic report.

World Economic Outlook

World economic slowdown has arrived….

Andrew Lilico said that he would begin by looking at world economic indicators. He noted that they show an economic slowdown is underway. But unemployment is still falling in Germany, France and the UK. Some modest rise in the US is underway. OECD leading economic indicators are still moderately negative. He is not looking at a 2008 type downturn; at least not yet.

Some bond yields in the euro area have fallen markedly in the last few months, of the order of 90 basis points in 2019. That is quite dramatic. US Fed fund rates rose a bit, but it is not clear where they are going next. Ten year US bond yields went down slightly. But US inflation expectations look stable. Andrew said that global broad money growth was showing signs of a slowdown.

Global monetary conditions have eased….

Trevor Williams asked him if they suggested anything more than a slowing in economic growth. Andrew Lilico answered that no, they did not. The broad money data showed nothing catastrophic happening to the world economy. Indeed, US broad money growth was accelerating Trevor noted. Peter Warburton said that quite a bit of US broad money growth was driven by banks' acquistion of Treasury securities, rather than lending to the private sector.

UK economic outlook

Andrew then moved on to the UK's economic picture.

UK economy has slowed markedly this year….

He said that UK growth was already weak, as was well known. We have not left the EU. UK growth is expected to decline a bit in the final quarter after a fall in Q2 and a rise in Q3. Business confidence is deteriorating and quite gloomy. Consumer confidence is holding up somewhat better. Export confidence is weak but has stabilised. Economic prospects in some of the countries we sell into are lacklustre and more fragile than in the UK, such as the euro area.

Andrew said that the UK PMI is weak for the construction and manufacturing industries. Services is not particularly healthy but is holding at around 50.

He noted consumer price inflation is weak, falling to below the 2% target and currently at 1.7%. However, it is expected by the Bank of England to hit the 2% target over the two year forecast period (as is usually projected), based on 0.75% bank rate.

…but monetary growth has stabilised….

Money growth seems to have picked up from some of the weakness shown earlier in the year. It had not fallen back further as was expected. But its long period of weakness in 2018 presaged the weaker growth in the economy in 2019.

Gilt yields are remarkably negative - well below zero. People are paying the government 1% a year for the privilege of lending to them in real terms. Sterling weakened a bit based on a no-deal Brexit but has sat within the range of 75 to 80 on its trade-weighted indexed it was in 2016 to 2018, said Andrew.

…and low unemployment and rising real wage growth suggest that recession will be avoided…

UK unemployment was still at multi-decade lows and pay growth was picking up in consequence. In nominal terms, pay growth is at its fastest pace since the global recession. In real terms, it is rising at around 2%, its most rapid pace since 2014 though not back to pre-recession in terms of levels. He said that the rise in nominal pay would reduce the burden of consumer debt.

Faster pay growth may be down to less immigration or down to catch up after a period of weak growth. Andrew Lilico said that pay rises were helping consumer confidence. Graeme asked if that confidence was about the broader economy or peoples' financial position. Andrew said it was probably the latter but that he would need to double-check.

…despite Brexit uncertainty

He said there is a lot of uncertainty around: Brexit ambiguity, export uncertainty, which were hitting the UK business sector harder than the consumer sector.

Debate

Trevor thanked Andrew for his excellent presentation and opened the meeting to debate.

Peter Warburton said that he would like to start with the issue of uncertainty, which was, of course, very high. He said uncertainty was about the policy environment, Brexit, trade, Middle east etc. Peter said that, in the past, these pseudo measures of uncertainty collated into an index were correlated with the Vix and other estimates of financial market volatility. He notes, however, that this relationship seems to have broken down over the last three years. Uncertainty measures are elevated yet volatility measures are subdued. Empirical estimates suggest that 50 to 75 basis points of the current slowdown in economic activity may be down to elevated uncertainty.

His point was that if we could deal with or resolve this uncertainty, then we could expect economic growth to recover and normalise, obviating the need for policy change. What needs to be done is to resolve the issues creating the uncertainty.

Andrew Lilico said that this sounds like the Krugman hypothesis. To the extent that uncertainty damages growth does its removal mean that the economy bounces back and its effect was therefore temporary, so policy should not overreact to an event created by uncertainty.

Peter responded by saying that the question then is about whether it is reasonable to expect the uncertainty to be resolved. For instance, you could get a narrow US-China agreement on tariffs but can the structural issues that led to the tensions such as intellectual property rights, cybersecurity etc. be readily resolved? Ditto, in the aftermath of Brexit, there might be a lot of residual uncertainty which means that you still do not have the clarity required for a bounce-back in investment.

There followed a broader debate about uncertainty and its economic and financial market drivers and their relative importance. Roger Bootle said he is not sure that the UK is much affected by the US trade wars with China, unlike maybe other countries, but in any event other factors are slowing the world economy. In the British case, however, Brexit uncertainty is a more tangible thing. If you are running a business in the UK, the sensible thing, given the uncertainty about elections, Brexit, etc. is to put off investing.

He argues, however, that firms are deferring the decision to invest not saying it will never be done. He agrees with Peter Warburton that when uncertainty ends, investment could bounce back. And further, that it is the type of investment that will come back, as it is in plant and machinery if only in a few years.

Graeme Leach brought in uncertainty being resolved in the housing markets, say for buy to let investors, and how that could unleash more activity post-Brexit. Roger argued, however, that a bounce in UK growth post Brexit could pose policymakers a problem, as it implies higher interest rates which could hinder a housing market recovery.

Graeme then asked why, if consumer confidence is holding up so well, that the housing market is in such poor shape. Peter said the authorities had hit the buy to let sector so its no wonder the overall housing market is so weak. Andrew noted that people might not believe that their homes are worth in reality what it may appear to in theory, and the fall in value when they try to sell it, confirms that view. Trevor pointed to other reforms in recent years that have acted to reduce housing supply by hitting landlords.

There was general agreement that, in this period of unusually high levels of uncertainty that UK fiscal policy was likely to be loose. Either because of a post-Brexit environment, after a general election or both. The real question is what this would mean for monetary policy.

Peter Warburton raised the issue of the sharp fall in bond yields and whether economic factors are sufficient to explain it. He would argue not. He says that yields have shrunk because the pool of acceptable high-quality collateral has fallen. Indeed, this may be a manifestation on uncertainty in a different way. The perception of what is core collateral has retracted. In Europe, it may be the Bund and maybe only one or two other sovereign bond markets. In the rest of the world, it may just be US treasuries. He says, of course, there may be some repercussions from Quantitative Tightening and overzealous restrictions in bank reserves. Still, it would be dangerous to ascribe all of the movement and gyrations in bond yields to economic factors. Andrew asked if this was a solvency issue. Roger asked if it was global. Peter Warburton answered that he thought the scarcity of high-quality collateral would, in time, be remedied by additional primary issuance of government debt. But in the near-term, yes, there was a solvency risk to the global financial system.

He argues that core money market participants seem to have a fear of counterparty risk, so this means less lending on an interbank basis, and hence the monetary system appears to be gumming up. There seems to be a concentration of interest in securities deemed to be of universally good quality.

Roger argued that macroeconomic factors could explain lower yields. Markets think that economies are fragile; interest rates are set to be lower even if they are negative already; inflation is going to be small; there are risks from pulling your money out of equities or real estate; governments are still safe despite high debt rates, so you pile in, driving down yields.

Peter argued that the bond market narrative makes little sense. The inverted yield curve is suggesting recession, but he does not think that the economic data suggests there will be one. Andrew suggested that it may mean that risk is being mispriced. Trevor posited that QE means that large portions of good quality government debt, up to a third in the EU, is held by central banks, so that means the private sector is chasing too few assets. Peter said he thought this was a financial market phenomenon, not an economic one.

Andrew further suggested that inverted or lower and negative yields could be a sign of a declining population or of a working-age cohort (its share falling as a proportion of the total). As people live longer, and the population ages, they save more, depressing interests rates. Peter acknowledged the logic of rising saving propensities due to longevity, but the reality is otherwise: people are carrying more debt into their old age and are not saving more. So, behaviour does not tally with the ageing population theory, and there seems to be more going on than economic theory suggests.

Trevor called the debate to a close and asked members to vote.

Votes are recorded in the order they were given

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Hold
Bias: To raise Bank Rate and to diversify QE holdings away from gilts

Peter said that he was not persuaded that we are on the brink of some macro-economic recession. Of course, conditions for recession could emerge over the next 12 months. But he observed the strength of the labour market, the pace of wage growth and low unemployment, and some monetary acceleration as well. At the earliest opportunity, we should resume the process of monetary tightening but for November he would make an exception and keep rates on hold. But he would retain a bias to tighten and to reinstate my call for rate rises fairly soon. Peter would like to see a diversification of the QE programme, perhaps including some infrastructure bonds and the sale of gilts.

Comment by Roger Bootle

(Capital Economics Ltd)
Vote: Hold
Bias: neutral.

Roger Bootle said that he would keep rates on hold. He said that in particularly uncertain times it is best for policy makers to do nothing. He suspects that economic conditions around the word are softening and things are looking highly volatile in the US. In the UK, data are softer: wage inflation has eased, and unemployment was up slightly. While not putting too much emphasis on this, he thinks there is potential for a significant bounce back in the UK in the event of a deal to leave the EU. So, rates could go either way, depending on the outcome of the Brexit negotiations.

Leaving with no deal is likely to result in a cut in rates but that may depend on the extent of a fiscal boost. Absent a Corbyn government, Roger sees a chance of the UK growing quite quickly, as catch up occurs. For now, he will leave rates on hold in the short term but reserves the right move them either way in the months ahead.

Comment by Andrew Lilico

(Europe Economics)
Vote: To Raise by 25 bps.
Bias: To Raise and withdraw some QE.

Andrew says that in all the discussions he felt that the right solution for all of them was higher interest rates. In a no deal scenario, the economy may slow but the pound would fall, inflation would then rise above target so the right response would be to raise interest rates. The fundamental reason is that so accommodative is the current stance that even in a no deal scenario it would still be loose.

In the event of a post Brexit shock like lorries backing up, port delays etc, low rates would not solve those issues. Other scenarios suggest that a post Brexit boom is possible, so the best thing is to get ahead of the curve, withdraw QE and raise rates with the aim of raising gilt yields to zero.

Comment by Graeme Leach

(Macronomics)
Vote: To Hold.
Bias: To ease.

Graeme said that he was concerned by the slowdown in the economy, the still too slow pace growth in broad money and signs of weakness in wage inflation and the employment data of late. Given the discussion about global uncertainty and in particularly around Brexit he would be inclined to leave rates on hold but retain a bias to ease should it prove necessary.

Trevor Williams

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

Trevor Williams said the economy had weakened over the last few months but was at risk of a deeper downturn depending on the Brexit outcome. A no-deal Brexit would likely require a ½% cut in rates, and possibly to zero, mitigated only by the extent of fiscal policy loosening. He would leave rates on hold, as the economy was still expanding by about 1% a year, probably the best it could do with Brexit uncertainty delaying investment spending and hitting the supply side of the economy via stagnant productivity gains. But with low price inflation, in the UK and around the world, the monetary lever is still an option. Albeit one in his view that carries long term challenges as zero or negative rates persist into a second decade with attendant long term consequences.

Even in a no-deal scenario, QE should not be used any further as it is warping the shape of the yield curve too much. Negative yields will damage long term investors, as they hold these bonds to maturity. A fiscal response alongside monetary loosening is the best that policymakers can do.

Contrary to many views, a Brexit deal does not end the uncertainty as the UK will only have withdrawn from the EU. It will then enter an indeterminate period of negotiating a longer-term trade deal with the EU, which could, or is likely to, entail a further extension to the current transition period or even a risk of leaving with no trade deal if that does not occur.

Deep structural reform, which will take time, and positioning the UK for the digital revolution that is underway, are the best ingredients required to help deal with whatever comes next over the coming years.

Comment by John Greenwood (in absentia)

(Invesco Asset Management)
Vote: To Hold.
Bias: To boost monetary growth.

No change in rates, but the Bank should take steps to boost money growth.

The MPC should keep rates on hold since marginal rate changes at current levels will make no difference to credit demand or supply. However, it is important to boost money growth which has fallen too low. There are three ways to do this within current "rules of the game": 1. add assets to BOE's balance sheet, or 2. ease LCR (Liquidity Coverage Ratio) regulations enabling banks to lend more to the real economy, or 3. ease capital requirements which, by requiring transfers from deposits, have gradually squeezed money growth.

Comment by Julian Jessop (in absentia)

(Independent Economist)
Vote: To Hold.
Bias: bias to raise.

Julian continues to believe that the next move in interest rates should be up, given the risks associated with a prolonged period of abnormally loose policy. A reduction in Brexit uncertainty would help. But there is a danger that any move now (in either direction) might have to be swiftly reversed.

Vote by Kent Matthews (in absentia)

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

Comment by Mike Wickens (in absentia)

(York University)
Vote: No Change.
Bias: None expressed.

Mike's vote is for no change. He thinks that monetary policy is a complete mess and has been for some time. There is clearly a hysteresis in interest rates: it is changes that matter and not levels which is contrary to conventional macro theory. Moreover, he thinks that negative real rates are due to monetary policy and not the real economy. To solve the problem, banks need to expand credit creation. More narrow money won't help.

Any other business

None

Policy response

1. Four of the committee who attended the meeting voted to keep rates on hold, with one member voting for an immediate rise by 25 bps.
2. Four other votes in absentia called for rates to be held, for now.
3. On a vote of eight to one the committee voted to keep interest rates on hold.
4. Brexit uncertainty in the short term was the main reason given for the recommendation to hold rates.
5. Four members recorded a bias to raise rates, two recorded a bias to ease and three recorded no bias.

Date of next meeting

14th January 2020.

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 and TW consultancy). 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 (Ruffer LLP), 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).