

# Shadow Monetary Policy Committee

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## Shadow Monetary Policy Committee votes Nine / Nil to Hold Bank Rate in May.

In its April 2020 poll, held via video conference, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of nine to nil, to hold rates in May.

The background to the vote is the extraordinary circumstances of the coronavirus crisis. Interpretation of these events was closely related to views taken about the severity of the crisis. Some saw the crisis as fundamentally arising from government over-reaction to the health crisis, thereby creating an economic crisis. These members expected the errors of governments to become apparent fairly rapidly, with a fairly partial rapid bounce-back in the real economy, albeit with large structural changes induced by the policy over-reaction, driving a rapid rise in inflation over the next eighteen months.

Others saw the crisis as fundamentally a health crisis that would have created an economic crisis even without government response (possibly a worse economic crisis). These members tended to be less optimistic about a rapid resolution of the crisis. Although they accepted that there might be inflation they also thought deflation possible and either way they saw such adjustments as potentially the price level transitioning to a new normal and that the process might involve such large disturbances in relative prices that normal inflation concepts were not fully applicable.

Four members expressed a bias to raise rates once the recovery takes place. Two said that QE should be reversed once the recovery takes place. Seven members cautioned against the money financing of the deficit. One favoured direct monetary financing of some portion of the deficit.

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.

### For Further Information on the Content Please Contact:

Andrew Lilico + 44 (0) 20 7269 2644 [andrew.lilico@europe-economics.com](mailto:andrew.lilico@europe-economics.com)

Trevor Williams + 44 (0) 7841 497791 [trevor@trevorwilliams.website](mailto:trevor@trevorwilliams.website)

## Votes

### Minutes of the meeting of 14 April 2020 (Held by Video Conference)

**Attendance:** Juan Castaneda, Tim Congdon, John Greenwood, Julian Jessop, Graeme Leach, Andrew Lilico (Chair), Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams.

**Apologies:** None received

**Chairman's comments:** Trevor Williams welcomed the members to the first video conferencing meeting of the SMPC and said that the only announcement he had to make is that this was the meeting when he hands over the chairmanship to Andrew Lilico. Andrew Lilico took the chair and invited Graeme Leach to make his presentation.

### Unprecedented times

Graeme Leach produced charts of the evolution of deaths from Covid-19 as of 13 April, which showed a flattening of the curve. He also cited analysis from the Centre for Evidence Based Medicine, at Oxford University, which suggested cautious confidence that a gradual lifting of the lockdown could occur from the end of the first week in May. This was the optimistic scenario associated with so-called 'hawks' in Government, who want to lift the lockdown as soon as possible. In contrast, he suggested that perhaps the more realistic scenario was that of the 'doves', for the lockdown and social distancing measures to be gradually eased from the end of May onwards. Press reports suggest there are 2 dates being discussed in Government for the beginning of the lifting of the lockdown; a hawk date of 5 May and a dove date of 28 May.

China – first in... first out.

Graeme Leach said that China was the first into the lockdown and the first out, but unlike in 2003-04 (when the Chinese economy averaged 10 percent per annum growth) the contribution to global growth would be less, with perhaps only 1 percent (year-on-year) growth in 2020. Latest statistics show that in 2020Q1 China's economy contracted 6.8 percent (year-on-year). Chinese growth in retail sales showed unprecedented falls for January-February, compared with the SARS dip in 2003. Year-on-year fixed investment showed a fall of 25-26% compared with a post-Sars spike that had been initiated by government investment. The Caixin General Services PMI data showed a massive drop in February and bounce back in March and this was the same for manufacturing. China is coming back, but with perhaps one tenth the post SARS GDP growth rate

Torn between de-leveraging and social unrest from unemployment.

He said that the government of China is on the horns of a dilemma. It cannot introduce a fiscal stimulus on the scale of what it did after the Global Financial Crisis. The banking system has more than quadrupled in size since 2008; total domestic debt is 310% of GDP; and shadow banking means that this figure vastly understates the true level of debt. The government problem is that it does not want the private sector to add to debt and was in the process of de-leveraging. Also the budget deficit was around 5-6% of GDP last year, which was a record. However, the fears of the CCP about unemployment and social unrest means that fiscal concerns will be overcome, but explains 'the halfway house' approach adopted up until now, in contrast to 2008-09.

US unemployment – off the map...

Graeme Leach said we were scrambling for data because the onset of the crisis was so quick. PMI data has been one of the most useful up to date sources. PMI data for services showed a cataclysmic fall for Italy and the eurozone area. PMI data for UK services showed a drop from just under 55 in February to below 35 in March. Manufacturing PMI has not dropped as much in March but further falls can be expected. Similar pictures are seen for US Services, but he said the image that was most astonishing, and had become iconic, was the chart showing the spike in US initial jobless claims which was quite literally off the chart.

GDP in Q2 ranges from -7.5% to -25%

In the context of Brexit, floods, and growth in Q4 of 2019 at almost zero growth, the UK economy was weakening going in to the crisis, suggesting GDP growth in Q1 is in the region of -0.1% to -0.5% but the real action will be in Q2, with forecasts ranging from -7.5% to -35%.

Resurrection, Restriction, or Resurgence?

Graeme Leach referred to the final slide of the presentation which showed three scenarios. He said that the scenarios will overlap. Each scenario has an associated list of descriptors that can act as defining parameters but not all need be satisfied. The first scenario is the 'Resurrection', which means a swift 'V-shaped' lift completed by end-June. This scenario has a bounce-back from repressed consumption, a stock market surge, a spike in the interest rate, a closing of the output gap, and the return of confidence.

U-shaped or L-shaped cycle?

The second scenario is the 'Restriction' which is a longer 'U shaped' recovery with a slower lift to be completed by end August. Here the government relief measures have limited impact, unemployment surges above 3 million, and there is inflation with contracting output. The pattern of recovery could easily turn into an L-shaped rather than U-shaped cycle.

Financial contagion and global meltdown

The third scenario is the 'Resurgence' case which is the 'Restriction' case followed by a second wave in infections in Autumn/Winter. This produces a second wave of unemployment and insolvencies, financial contagion, deflation and negative interest rates or an interest rate hike and a super-stagflation. This could end up with monetisation of the debt, Trumpian type trade policies, and global meltdown. Graeme Leach said that the scary thing is that if there is not a removal of the lockdown soon we can quickly move from the 'Restriction' scenario to the 'Resurgence' scenario which results in armageddon economics, which could-kick in if there is a second wave of the pandemic.

## Discussion

Andrew Lilico thanked Graeme Leach for his presentation and analysis. He said to discipline the discussion he thought there were four sections for discussion. The first is on the scenarios, which is about the medical evaluation and crisis evolution. The second is on the economy, meaning GDP, unemployment and the structure of the economy during the crisis period. Third, is on what is going to happen to inflation. Fourth, is on the longer term implications, such US strategy viz China, future of international travel, trade wars etc.

Crisis duration ....

Starting with the scenarios, he said that the OBR has a scenario of 3-6 months. There is a 3-month strong lockdown and in 6 months magically we are back to normal. He said that Graeme Leach had a most pessimistic scenario that goes out to 12 months. He said that he has been discussing three scenarios with his clients. These are 3-6 month, a 12 month, and 18+ month scenarios. In the final scenario there is an economic scarring that lasts till 2025. He said that some of the scenarios people are thinking about are based on the notion that the crisis will be quite short. He said that he was interested in what other people thought about the duration of the crisis.

Exit through herd-immunity

Julian Jessop said precedents from elsewhere point to a duration of 3-6 months, which is probably right. There is not just the damage to the economy, but also to broader health. In the UK as resources shift away from non-coronavirus patients there will be growing pressure on the government to end the lockdown. He said that the exit from the crisis has to be some form of herd-immunity, either through vaccine or naturally through infection.

Peter Warburton said that he leaned towards the longer timescale. Much of the emerging world is still at an early stage in its experience of the disease. These countries lie at the base of global supply-chains and they are also the weakest in

Supply chain weakness

terms of health care and least able to enforce social distancing. The unfolding damage to poorer countries where fiscal relief is limited will leave supply-chains depleted. The restarting of supply chains if the west comes back early will result in supply shortages and an inflationary backlash

Failure to tighten policy at the right time.

Trevor Williams said that the demographics of the emerging economies are an important factor. Some of the emerging economies have a young population which suggests that this virus could be more of a rich world issue than a third world issue. There is some evidence that supports this already but of course some will be badly hit in terms of income and unemployment. On the matter of supply chains, he said that there will be a reluctance to reverse the huge policy loosening initiated by governments in a timely way when recovery starts and that will be the reason for inflation to take off.

China numbers untrustworthy

Tim Congdon said that this virus is clearly bad for older people, but mortality is very low among the young (say, under the age of 40) and ending the lockdown would enable this group to achieve herd immunity within three months, so that they could live as normal. ~~will develop in the 3 months~~. The figures for China cannot be trusted because they have an authoritarian system. They can open the economy and allow the death rates of the old to rise without challenge, and the economy can recover if at high cost in elderly lives.

Andrew Lilico asked members for views on the sustainability of the economy if GDP fell by numbers like 30% a quarter for two quarters? Julian Jessop said that are too many gaps for the Treasury to cover and at some point there will be a downward spiral of the economy which will be uncontrollable. Graeme Leach said that this was the second scenario merging into the third if not checked. Trevor Williams said that a gradual opening can occur taking into consideration geographic, sectoral, and demographic factors with the help of telephone app technology.

Andrew Lilico said that moving onto the economy, the figures being forecasted vary from 7.5% to nearly 35% and this is a wide gap that should be discussed. He asked for opinions.

Underestimation of the rate of growth of infection...

Patrick Minford said that the costs to the economy are quite intolerable and the fall in GDP is likely to be at the lower end of the range, partly for the reasons provided by Tim Congdon, but also because there has been an underestimation of the progress of the rate of infection. An examination of the Wuhan data suggests that there is a doubling of the infection rate in every 3 days. Assuming that the infection started in February, the rate of doubling means that the virus has ripped through most of the population by now. Applying an initial value of 2000 in February, you reach 50 million in 37 days.

Andrew Lilico said that he also did some mathematical modelling and said that his calculations using Imperial College type assumptions suggested that the infection rate by end-May is unlikely to be much above 20% which is a long way from what is needed for herd-immunity. He said that the economy may be more flexible than people think. There is evidence that a higher proportion of higher earnings jobs can be done at home and spending patterns moving to online buying may mean that the measures of GDP will need to be revised. He said that there is a demand and a supply reduction and the effect on prices will inform the inflation outcome. He said that he wanted to hear views on the prospects for inflation.

UK inflation of 10%...

Peter Warburton said that there are two elements to be considered. First, the natural recovery of the private sector, and second, the delayed impact of the fiscal response to the crisis, kicking-in just when the private sector is recovering. Along with supply chains being broken there is the potential for a flash point in inflation in about 6 months' time. Graeme Leach said that if monetary growth remains the same, deteriorating output growth means higher inflation. Tim Congdon said that monetary growth in the US could rise to as high as 15%, so there is a potential for

inflation. In the UK he did not expect it to be as bad but inflation of 10-12% is feasible.

Patrick Minford said that the key moment is the re-entry. Inflation comes when the uncertainty of the end of the lockdown is resolved. The great danger is that the monetary taps are kept open in the 'Resurrection' period. There is a need for monetary policy to tighten up which will have the effect of devaluing the debt. Andrew Lilico said that there is the potential for relative prices to rise and during the period of adjustment to demand, the basket of goods in the CPI will not reflect the actual purchases of households and that there may be a measured spike in inflation of goods that are not being bought.

Julian Jessop said there was a danger that the official inflation figures in the coming months will be misleading, both because of a low number of transactions for many goods and services and because of distortions in the prices of others, such as a reluctance to raise prices due to the bad publicity retailers would face for hiking prices during the crisis. Combined with lower commodity prices, especially oil, there could be some very low or even negative inflation numbers, which may make the MPC underestimate the inflation risks over the longer term.

Andrew Lilico asked the committee to vote on monetary policy. He asked Graeme Leach to start the vote.

**Votes are recorded in order they were given**

**Comment by Graeme Leach**

**(Macronomics)**

**Vote: To Hold**

**Bias: No bias**

Graeme Leach said that the authorities were trying to flatten 2 curves simultaneously; the Epi curve (to weaken the pressure on the NHS) and the recession curve (due to containment policies). The inverse relationship between the two is deeply concerning and means that if containment policies don't begin to be eased significantly, by the end of 2020Q2, any V shaped economic bounce-back will become less and less likely. Assuming they do begin to lift, and are removed completely by 2020Q4, a V shaped recovery is more likely. However, the lesson of economic history, from the Spanish, Asian, Hong Kong flu and SARS outbreak is that short and mild pandemics can be followed by swift economic recoveries, but the bigger the pandemic (in terms of morbidity and mortality) and the deeper the associated economic downturn, the less likely a quick recovery will be made. This concern has led to an unprecedented policy response with the Chancellor introducing the biggest fiscal expansion in UK peacetime history, and the Governor of the Bank of England refusing to rule out the possibility of helicopter money. The world has changed a lot very quickly. The budget deficit is likely to be permanently monetised to some degree, and the banks are being encouraged to increase their lending (by government guarantees), in sharp contrast to the financial crisis when the authorities mistakenly chased banks to rebuild capital. As a result, money supply growth is likely to accelerate not decelerate. This will bring higher inflation moving into 2021. If a heavy lockdown were to continue to be enforced for 9 or 12 months, devastating economic scenarios could come into play. Assuming such containment measures are not required, the end of the lockdown, and Say's Law, should gradually reverse the collapse in the economy. The longer the lockdown lasts though, the greater the threat from hysteresis effects and a more L shaped recovery. Accelerating money supply growth and a flat recovery, brings with it the prospect of stagflation with higher unemployment and inflation.

### **Comment by Trevor Williams**

**(University of Derby and TW Consultancy)**

**Vote: Hold**

**Bias: Bias to raise.**

Trevor Williams said that interest rates should be kept where they are. They are rightly at emergency levels. He said that he doesn't like the use of the 'Ways and Means' facility to fund the gap between government spending and revenue as it is direct monetisation of the government debt. Money should be found somewhere else by the Bank of England to offset its impact.

He would reconsider the QE programme once recovery is underway. In addition, there is enough help being given to the banks to provide liquidity to companies, but the evidence is that they are not doing so. The Bank of England should therefore take further action to ensure they are complying or alter the scheme and provide more direct funding. . Once the recovery begins to take hold in early next year, interest rates need to get back to ½% and QE should start to be reversed.

### **Comment by Tim Congdon**

**(Institute of International Monetary Research, University of Buckingham)**

**Vote: Hold**

**Bias: No bias**

Tim Congdon said that there has been a huge discretionary increase in the budget deficit. The critical issue is whether this is to be funded by the banks or the rest of the economy? He questioned whether the burst in money growth that is going to come be retracted sometime in the future? He questioned if in 6 months' time how is the rapid growth in debt to be financed? He said that he hoped that the one-off increase in the price level is what the Bank of England says it will be, and monetary growth returns to normal, but he was pessimistic.

### **Comment by Patrick Minford**

**(Cardiff Business School, Cardiff University)**

**Vote: Hold**

**Bias: to raise.**

Patrick Minford said that the key issue is that government must finance the spending at the long end at current low interest rates, that is buttressed by QE in keeping long rates very low. This policy must continue until the 'Resurrection' when there must be an inflexion in policy so that monetary policy be tightened, and interest rates start rising. The rise in rates will also raise long rates. Then only a small rise in tax rates is necessary on a permanent basis to keep government solvency. He said that he was not in favour of allowing the price level to rise which should be headed off with a rise in rates.

### **Comment by John Greenwood**

**(Invesco Asset Management)**

**Vote: Hold Bank Rate. To continue with QE.**

**Bias: To reverse QE to mop up excess money.**

John Greenwood said that we are likely to have an initial period of misleading deflationary conditions, which will see an acceleration in money growth. The issue is whether this excess money growth will be withdrawn? In the post GFC period although central bank balance sheets expanded there was not a commensurate growth in broad money. In the current case there is greater danger of rapid growth of broad money, either through monetization and/or keeping interest rates very low because of the fear of deflation. After this period of deflationary syndrome, we need to get back to money growth being at the centre stage. Interest rates should stay where they are but action to be taken to mop up the excess money growth in the recovery.

### **Comment by Juan Castaneda**

**(Institute of International Monetary Research, University of Buckingham)**

**Vote: Hold and maintain QE**

**Bias: Reverse QE in the recovery**

Juan Castaneda said that there has been a surge in broad money data in the USA. Some describe this as a one-off, but he said that the monetary financing of a significantly increased budget deficit will accelerate broad money growth in 2020 even more, which signals an inflationary period in the USA in 2-3 years. In the UK, the deficit will see an increase in broad money and the Bank will face pressure to finance the deficit. How much and how long depends on the scale of the deficit. The scenario is also inflationary in the UK. He said that interest rates should be on hold and QE reversed once the recovery is under way. He said that he was not optimistic.

### **Comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: To Hold**

**Bias: No bias**

Peter Warburton warned that a transition to fiscal dominance was underway, where monetary policy becomes increasingly irrelevant and subsumed to the broader political environment. Politicians will like what they see when inflation comes through and that central banks will lack the authority to counteract it. Real interest rates will be negative for some time. We do not have a financial sector balance sheet crisis this time as we did with the global financial crisis. What we have is a corporate profitability crisis which has been met with a massive fiscal rescue package. He expects an inflation backlash with little or no scope for a tightening of monetary policy. He voted to hold.

### **Comment by Julian Jessop**

**(Independent Economist)**

**Vote: Hold.**

**Bias: To raise.**

Julian Jessop said that with everyone else he saw no reason to change monetary policy now but continues to have a bias for tightening. In addition to the general point that an extended period of very low interest rates is unhealthy, there are now specific concerns about rapid money growth. In particular, if the Bank of England feels that it is being leaned on by the Treasury to monetise government borrowing,

for example by extended use of the 'Ways and Means' facility, it should try to offset this elsewhere.

Julian Jessop said that with everyone else he saw no reason to change monetary policy. He said that he continues to have a bias for tightening. If the Bank of England feels that it is being leaned on by the Treasury to lend to the government, it should find means of offsetting this. He said that he was not able to specify how this could be done but felt that funding through 'Ways and Means' is to be avoided.

### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: To Hold**

**Bias: None.**

Andrew Lilico said that he was more pessimistic than the rest of the committee about the duration of the crisis. He said that he does not feel that the government has a good strategy for bringing it an end very soon. On a deeper level, if this situation is not resolved very quickly, he said that there will be big structural changes to the economy. He said that he buys the view that there will be more home working, more online buying, less air travel and so on. Governments will be more restrictive on immigration and on short duration travel. He said that these structural changes to the economy means that it is hard to say what the correct price level will be. He said it will be too difficult to fine tune the price level and it may be better to simply let the price level be what it will be – i.e. to simply accommodate the price level shifting (up or down) for a period – say, 18 months. He said that where he also differed from everyone else on the committee is that he had sympathy with the idea that the government should use the central bank to directly fund the deficit in the way that was done in the 1970s. This is something the government knows it can do and have an effect: the government can print money and buy stuff. Faced with a 30% decline in GDP, the government will want to do something it knows will have an effect. He said that there should be no change in interest rates. Somewhere down the line once a view is taken about the price level, he could see the case for tightening.

### **Comment by Kent Matthews**

**(Cardiff Business School, Cardiff University)**

**Vote: To Hold**

**Bias: to raise and reverse QE.**

Kent Matthews said that clearly nobody wants to see a rise in interest rates at this point. He said that the SMPC had discussed the need to raise interest rates in the past so that monetary policy could be actioned in times of emergency. It is now too late to talk about monetary policy. What we are witnessing is a negative supply shock and a less than equivalent fall in demand because of the government income support policies. The result is there will be a rise in the price level whatever else happens. This is like the stagflation of the early 70s. He said that the economy is always evolving and going through gradual structural change and there will always be a bias in the measure of the price level. The virus may have hastened that process and there will be relative price adjustments going on that will muddy the measure of inflation. However, there is no need to throw out the lessons of monetary policy from the 70s stagflation because of a severe real economy shock. Money financing of the deficit will result in an inflationary spiral that must be avoided. He agreed with Patrick Minford that the deficit should be bond financed at current low interest rates. Inflation may rise in the short run once the recovery begins. The Bank needs to signal that monetary policy will be ready to lean against

inflation from rising permanently. He voted for interest rates to remain on hold with a bias to raise and a reversal of QE once the recovery occurs.

### **Any other business**

Nine votes will be taken although ten members attended. In keeping with precedent, the vote of the last person to join meeting will not be counted. This was John Greenwood. His views are recorded in the Minutes

### **Policy response**

1. There was unanimity that interest rates should be kept unchanged.
2. Four members expressed a bias to raise rates once the recovery takes place.
3. Two said that QE should be reversed once the recovery takes place.
4. Seven members cautioned against the money financing of the deficit.
5. One member expressed sympathy with the notion of money financing the deficit.

### **Date of next meeting**

14 July 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). 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).