

# Shadow Monetary Policy Committee

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31 July 2020

## Shadow Monetary Policy Committee votes unanimously to Hold Bank Rate in August.

In its meeting of 14<sup>th</sup> July 2020, held by video-conference due to ongoing COVID-19 restrictions, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of nine to zero, to hold rates in August. Five members favoured holding Quantitative Easing (QE) at its current level. Two favoured reducing QE. Three expressed a bias to raise rates as soon as recovery took hold.

The background to this decision is the worst recession in the UK since at least the Spanish Flu pandemic of 1918. And yet, at a 19% contraction in GDP that may yet not be as bad as feared earlier in the coronavirus crisis. It was noted that with a very large rise in the money stock coinciding with a very large fall in GDP, it should be no surprise that asset prices are rising.

Most members took the view that current policy action is directed at supporting the liquidity of fundamentally sound firms during a large temporary disruption. However, it was noted that (albeit understandably and perhaps intentionally) policymakers have “done too much rather than too little” and boosted asset prices. The Committee explored to what extent the (very large) supply shock component to the current contraction is likely to be enduring as well as temporary, potentially meaning policy is supporting large numbers of long-term unviable firms as well as firms facing only temporary problems. A number of Members took view that rapid recent money growth will (growth in money demand notwithstanding) lead to more rapid inflation over the medium-term.

For now, however, the Committee agreed that policy should not change.

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 14 July 2020 (Held by Video Conference)

**Attendance:** Juan Castaneda, John Greenwood, Graeme Leach, Andrew Lilico (Chair), Kent Matthews (Secretary), Peter Warburton, Trevor Williams.

**Apologies:** None received

**Chairman's comments:** Andrew Lilico welcomed the members to the second virtual meeting of the Shadow Monetary Policy Committee and invited Trevor Williams to make his presentation.

### The worst recession since the 1918 flu pandemic

To set the scene, Trevor Williams began with a quotation from Charles Mackay (1832), *Extraordinary popular delusions and the madness of crowds*, 'In reading the history of nations, we find that, like individuals, they have their whims and their peculiarities; their seasons of excitement and recklessness, when they care not what they do. We find that whole communities fix their minds on one object and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion and run after it, till their attention is caught by some new folly more captivating than the first.' He said that his presentation will be made up of four parts consisting of the global monetary and economic backdrop, the UK focus, lessons from the deep history of long term rates, and a discussion of research on savings and long term real interest rates.

His main presentation started with the global monetary and economic backdrop. He presented the latest outlook from the IMF which showed that they had become more pessimistic about the global downturn. The projection is for a widespread and severe downturn in advanced and emerging economies. One of the issues is that the recovery that the IMF is showing for the UK puts it behind the other advanced economies. He said that he was not as pessimistic as the IMF, but the profile of the drop in output is going to be of this order of magnitude and the recovery would be gradual.

Loose monetary policy.... misaligned asset values.

The policy response has been to loosen aggressively. Short term and long term rates were lowered to near zero or in some cases negative levels. Central banks have joined in with strong quantitative easing. Measures of monetary conditions show a loosening everywhere. The latest broad money supply figures show a sharp increase in growth in recent months, even Japan, with the USA highest at 17.5% year-on-year in May. The result of this loose money is the increased misalignment of asset prices from real economy fundamentals. The IMF measures of asset prices valuation shows gross over-valuation in most countries and most asset classes.

Low inflation for now but risks from supply constraints

He said that at the same time, public sector debt has reached record highs, parallel with WW2 in advanced and emerging economies, as a whole (but not the UK where war time debt levels are far higher than current ones), with all the implications for funding and fiscal balance. If growth picked up faster than expected, debt ratios will stabilise. However, global inflation remains low with the fall in demand and with commodity prices falling since the start of the year. OECD producer price inflation has bottomed out at -3.5%. Consumer price inflation is not negative in any of the major economies – yet - even Japan but supply restrictions are beginning to emerge. He said that global inflation is low for now, but emerging supply constraints create the risk that inflation could return.

GDP shrunk by 19%, but not as bad as expected.

The next part of the presentation focussed on the UK. Turning to the latest figures from the ONS, he said that in the three months to May, the economy had shrunk by 19.1%. Trevor Williams said that this was clearly bad news, but not as bad as previous Treasury projections of around a 35% decline. The contraction was widespread across all industries, particularly in Accommodation and Food Services. One of the reasons why the UK is particularly badly hit is because it has a well-developed service sector. A whole host of high value-added industries were particularly hard hit. Hence services make up 15.14 percentage points of the 19.1% decline. But recovery is under way with the ONS monthly index showing an upturn. Absent another lockdown, the next quarter will show a double digit pick up.

Recovery, but permanent loss of output...

The problem of low productivity growth is shown up in the cumulative hit to the supply side from the Covid-19 shock, in the figures illustrated in the chart produced by NIESR. Output will recover, but will lag behind the pre-Covid-19 trend for some years. The NIESR estimate that the cumulative lost output to 2024 to be £430 bn. But there are grounds for optimism, he said. The economy has bottomed out at a higher level than expected, recovery is under way, and money supply growth is rebounding.

Bank deposits growing faster than loans

On the money supply figures, Trevor Williams said that it was noteworthy that deposit growth is faster than lending growth which means that the banks are not lending as fast as they could. But businesses are borrowing more. The sectors that are borrowing more are Real Estate and support services and a little from Construction, and Transport but not so much from Manufacturing. Manufacturing had done its borrowing earlier. Loans are preferred to bonds or equity finance. Households are also repaying debt.

Lockdown easing and consumer recovery

Turning to employment, Trevor Williams said that the data shows a sharp fall in employment and hours worked. Figures from the ONS of VAT turnover show a steep decline in corporate activity. On the consumer side footfall is up in June/July but still 50% below where it was in the same period of the previous year. The improvement is an indication that the lockdown is easing.

Supply chain disruption eased but still there...price pressure yet to come through.

Prices for certain consumer goods have returned to pre-lockdown levels in March, but has fallen again in the recent week. Food prices have remained stable. Another set of data the ONS is pushing out is shipping activity. The figures show that the trend of (all ships) shipping activity has picked up from its lows in April. The pace of shipping activity has stabilised at a low level compared with the start of the year. This pattern implies that supply-chain disruption has levelled off and is not getting any worse but is still there and price pressure has not come through yet.

Overvalued asset prices could lead to another market crash

Trevor Williams said that before he ends his presentation he wanted to make some points about monetary expansion. He said that once the virus is under control, the money creation to deal with the crisis will still be out there. Inflation is delayed by the collapse in commodity prices and the fall in demand. As the economy recovers, it will reach the bottlenecks that spark price rises. If policy is not tightened, then we may see inflation rising. The risk is that nothing will be done and policy makers don't act quickly enough as they will be worried about ending the recovery early. The answer is not to raise taxes to pay down the debt but to grow our way out. Technological progress has not slowed. Asset prices are overvalued and sound money and finance is required.

Real rates have declines secularly for 5 centuries....

This part concluded the presentation about the global and UK monetary and economic backdrop. Trevor Williams said he wanted to mention some research that is coming out of the Bank Underground. He referred to research at the Bank of England that has looked at the history of pandemics and its effect on long-term real rates of interest. The results of the research show that real rates fall for up to 40 years after a pandemic. Other research has shown that real rates have been falling in Europe for 500 years. The question Trevor Williams posed is, could this

lower real rate be a way of funding deficits and to avoid the inflationary consequences? Lower real rates have not stopped technological progress and there is no reason to be pessimistic about the future. He referred to the Appendix of the slides to his presentation where he summarised the research which shows that historically, real rates have been declining secularly for 5 centuries.

## Discussion

Andrew Lilico thanked Trevor Williams for the presentation and his insights. He said that the key points are; GDP down 19 percent, Money supply up 21 percent (Juan has circulated the latest broad money data that shows that UK money supply growing faster than other countries in the past three months); so asset prices are inevitably rising. He asked for comments and questions.

Optimism and technological inflexion

Graeme Leach said that he wanted to reinforce the confidence points concerning the long term effects Trevor Williams had touched on. He said that he had written about the long lags between technical innovation and full implementation. The analogy is the 'roaring twenties' that followed the Spanish flu. He said that it may be that following the current pandemic we would experience a similar point of technological inflexion. To the technological factors mentioned by Trevor Williams he would add AI, 5G, internet of things and the interaction of these three to define a point of technological inflexion.

Real effects of changing preferences

Andrew Lilico questioned whether the virus crisis might change peoples preference for leisure. As a result of 'learning by doing' of something people have been forced to do, they change their preferences. People may be content to work fewer hours a day and consume more leisure. He asked if this a plausible outcome and if we need to worry about it? Trevor Williams said that there was an inequality between those who could make that choice and those that cannot. He said that there will be changes in work practice for those high value-added jobs who have the flexibility to do so, but not for many others. Graeme Leach said that it may result in a narrowing of income differentials but widening of work hours and practice.

Supply side will define the shape of the recovery

Peter Warburton said that the crisis is prompting significant supply side shifts which make it unlikely that pre-crisis capacity will be fully restored. Businesses that were previously profitable at near-full capacity may not be viable with the same cost base at 75 per cent capacity. Acceleration of switch to online ordering has persuaded the department store John Lewis to close some flagship branches, including its branch in Birmingham city centre. Business divisions or branches that are not contributing to group profit are likely to be closed, with serious job losses. Optimising businesses to operate at a lower level of capacity will have significant effects. While there is more flexibility in smaller businesses, big companies will struggle to come back in the same shape or size. John Greenwood added that the shape of the recovery will be defined by the supply-side adjustment. The bounce back to 90 percent of the pre-covid level is straightforward and will be 'V' shaped but then there will be a period of reallocation of labour and capital which takes time and that will result in a longer period of recovery resulting in the square root shape. He said that he agreed with Trevor Williams that economies that are more heavily service oriented will take longer to recover than those that are more manufacturing oriented.

Inflation figures untrustworthy.

Peter Warburton added that he is wary of the CPI measure of inflation. He quoted research work that has reweighted measures of prices based on actual spending post-lockdown, which suggest that prices are 100-150 bp higher than the measured CPI. The MIT's billion prices project, which scrapes prices quoted on the internet, reports a rebound in US consumer prices: June readings are above the February level. A separate point is that, the GDP deflator, which is less affected by changing consumer patterns, has not fallen as sharply as the CPI, either globally or in the USA.

Monetary policy response to real shocks?

Kent Matthews said that inflation should be seen as a sustained increase in absolute prices and not just a series of relative price changes in response to various supply-side and productivity shocks. He said that interpreting the monetary aggregates are important, but the evidence that Trevor Williams produced about the growth of deposits suggests that households are increasing their precautionary demand for money. When the demand for money outstrips the supply of money the adjustment is firstly in output, and then later in prices. He asked Trevor Williams to explain what he thought monetary policy could do when faced with real shocks?

Trevor Williams said that he agreed that the shocks are real ones and that monetary policy should not react to short term events but longer terms ones. The economy cannot be fine-tuned. Monetary policy should be neutral guided by a neutral rate. The issue is what is that neutral rate?

Policy not aimed at asset prices...but aimed at the real economy

Andrew Lilico said that he had two questions relating to monetary policy. First, what do the authorities think they are doing regarding the increase in broad money? Second, what is the mechanism that they see as how this will change into inflation? Trevor Williams said that we already see asset price inflation. He said that monetary policy has overdone the easing and asset price inflation has been the result. Andrew Lilico asked whether the purpose of the policy is to make it easier for companies to raise equity so that they can invest. Trevor Williams said that that was the aim but that it did not make sense to prop up businesses that should have gone bust through cheap money. John Greenwood said that Jay Powell (Federal Reserve) was asked the same question. The line he takes is that policy is not aimed at asset prices but first, to enable firms and households to obtain credit and second, to enable the economy to recover. If as a side-effect there is asset price inflation that is not a concern.

Monetizing the deficit...moral hazard

Juan Castaneda said that he agreed that policy makers are not targeting asset prices, which is an unintended side-effect. He said that it is important to not underestimate the coordination of fiscal and monetary policy and the financing of the very large deficits. In the USA, the Federal Reserve has declared their willingness to support the Treasury by monetizing the deficit. He said that this was the aim of policy. Trevor Williams said that monetizing the deficit is one thing, but buying sub-investment grade bonds and flushing the banking system with liquidity is creating moral hazard in markets and creating future problems, creating unnecessary problems for the future.

Tobin's Q versus Friedman's Helicopter

Kent Matthews said that the question is, who is getting the money from monetary loosening? The route described by Trevor Williams is supposed to work through the 'Tobin Q' effect but it is not working. Money financing of the deficit is much closer to 'Friedman's Helicopter' and has a much better chance of getting money into the hands of the non-bank private sector who are more likely to spend it rather than the banks. As it is, money is not getting into the hands of those who need it, like SMEs. Graeme Leach said that the biggest difference between the response to the current crisis and the Global Financial crisis (GFC) is that in the GFC the policy was to expand money supply through the central banks but shrink money from the commercial banks. In the current situation both sources are being encouraged to expand money.

Government signals no confidence in economy to create employment...

Andrew Lilico said that he did not understand what the government's fiscal policy or monetary policy strategy is. They wanted economic activity to be less as this was related to the spread of the virus. But they don't seem to have any confidence that the economy will create employment in the recovery. The government seems to take the view that there is some problem with the economy in creating jobs and require a whole range of job-supporting policies. It is well-known that there is going to be some increase in unemployment. Possibly 15% of those furloughed will be made unemployed. It seems that the government lacks confidence in the economy to recover on its own, and current policy is about confidence creation and

Loan Guarantee  
Scheme lacks  
transparency...

signalling that the government is seen to be doing something, which he concluded was a very woolly kind of economics.

Peter Warburton said that the lack of visibility associated with the government loan guarantee schemes is a problem. He said that if there was confidence that the loan guarantee schemes were providing bridging credit to healthy businesses, then that would be acceptable, but we don't have that reassurance at all. What is happening is that the government is emboldening a lending to poor quality borrowers that a year later may be regarded as impaired. He said that the lending was concentrated in the hands of larger sized companies. He was concerned that when we exit from the crisis we will have accepted as a *fait accompli* a much more socialized economy.

Juan Castaneda said that point has already been made that compared with the GFC both monetary base and broad money are surging. He said that he did not think that the monetary authorities have a sound plan. In USA broad money (as measured by M3) is growing at the fastest pace in modern (peacetime) history at 26.7% (June 2020). Once the pandemic is under control, this money has to go somewhere. It is already going into asset prices but eventually it will go into spending.

Andrew Lilico asked the committee to vote on monetary policy. He asked Trevor Williams to start the vote.

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

**Comment by Trevor Williams**

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

**Vote: Hold Bank Rate. No further QE**

**Bias: Bias to raise once recovery is under way.**

Trevor Williams said monetary policy should stay on hold with rates at 0.1% until the pandemic is over and or a workable vaccine is found. Once the economy shows signs of recovery QE should be reversed (first through not reinvesting the proceeds of maturing bonds) and then gradually by interest rates being raised back to an equilibrium level.

**Comment by John Greenwood**

**(Invesco Asset Management)**

**Vote: Hold Bank Rate. No further QE.**

**Bias: None**

John Greenwood said that Bank rate should be left where it is, and the existing £100 billion proposed for QE should be used, but after that no further QE. The purpose of policy is to support businesses with bridging credit and that is why the government has signalled the willingness to take on the additional amount of debt on its balance sheet. The economy is well-oiled with liquidity. The problem had been, as the Bank described it, that there was a 'dash for cash' in March-April as people shifted from higher risk assets to cash. This increase in the demand for money is not over. MMFs in the USA have gone from \$3.2 trill to \$4.2 trill. This risk-aversion will remain in the system and people will not go out and spend. Clearly longer term there is a problem with this excess liquidity. Reversal of QE is not such an easy thing to do. QE can only be reversed if it is matched by strong bank lending growth. There is a need to think about the role of central banks that

have very large balance sheets. The biggest contrast between the current crisis and the GFC is that banks are in good shape now and therefore they can be part of the solution. Lending to the larger corporates has been strong. It is premature to move to a tightening phase in monetary policy. Talk of monetary financing of the deficit in the UK and USA is incorrect. In fact, there has been no “monetary financing” of the deficit. In the US, the deficit has been fully funded by a policy of issuing T-bills and in the UK the DMO has been fully funding the deficit by issuing gilts and indexed linked bonds. The Bank of England ‘Ways and Means’ account has not been used. The DMO has been successful in funding the deficit through the non-bank sector.

### **Comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: To Hold Bank Rate.**

**Bias: No bias**

Peter Warburton said that there was no basis to signal a tightening of monetary policy and Bank Rate should remain at 0.1% with no bias. Regarding the £100bn expansion of QE, he suggested that this should be used to buy infrastructure bonds or funds rather than gilts, giving more substance to the government’s commitment to rebuild the economy.

### **Comment by Graeme Leach**

**(Macronomics)**

**Vote: To Hold Base Rate. QE unchanged**

**Bias: No bias**

Graeme Leach said that the economic outlook is strongly dependent on the epidemiological outcome and so given the uncertainty at present any change in monetary policy at this stage would be unwise. It is also questionable as to whether any further action is required at present. There is a massive fiscal stimulus and interest rates are nudging against the zero bound. Broad money growth is in double digits and so a significant monetary stimulus is in place. Indeed, the rate of broad money M4X growth is likely to lead to an upsurge in inflation in 2021. In the short-term though the effect of the crisis has been to weaken inflation due to the scale of the downturn and increase in unemployment. The monetary stimulus has also been weakened by a fall in the velocity of money. As the lockdown is lifted inflation is likely to pick-up initially because of catch-up effects with a surge in demand for certain services. However, as this effect fades a more powerful inflationary force will begin to feed through the system given the scale of money growth. As yet broad money growth in the UK (and in the US in particular) has fed through into asset market prices. It is only a matter of time until it feeds through into general inflation.

### **Comment by Juan Castaneda**

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

**Vote: Hold Base Rate. Cancel QE**

**Bias: No bias**

Juan Castaneda said that interest rates should stay on hold and QE be cancelled. He said that he did not favour a reversal of QE for the reasons suggested by John Greenwood and that we had to wait and see how the economy progressed in the next few months and the progress on the availability of a vaccine. In the medium to long term, money velocity will revert to normal levels. At the moment it is very low, but the enormous amount of money created will still be there when the demand for money returns to more normal levels. The result in the medium term will likely be higher inflation.

### **Comment by Kent Matthews**

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

**Vote: To Hold Base Rate. No further QE.**

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

Kent Matthews said that QE was not doing what it was expected to do and should be stopped. That does not mean to say that the Bank should not try to use monetary policy to stimulate the economy. He said that he liked Peter Warburton's idea that QE should be diversified into financing infrastructure projects. He said that households and firms have increased their precautionary demand for money and are not spending. Once the recovery begins, households will reduce their money demand and start spending. There is clearly an inflationary risk, but we cannot wait for the recovery to come naturally and the government has to get money into the hands of people and stimulate expenditure. There is more chance of that happening by financing the deficit through 'ways and means' than by the current process of QE. He said that he did not think the pandemic will last for long and things will normalise much faster than people expect. When the recovery occurs, households will reduce their precautionary demand for money and start spending and that is when the Base rate should be raised, and QE reversed. Base Rate should stay where it is with a bias to raise. The deficit should be financed by money creation and QE be reversed once the recovery takes hold.

### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: To Hold Base Rate. Continue with QE.**

**Bias: None.**

Andrew Lilico said that he remained more pessimistic than the rest of the committee. He said that there has been no cure or therapy for the virus that has been successful. He said that we should assume that we will be in the pandemic phase for a while yet. Further lockdowns may occur in the winter on a regional basis. He said that he was pessimistic on that score. He did not think that the economy was in some kind of sustained recovery phase. The question he posed was how we get back to normal while the economy is still in the pandemic phase. He said that he favours direct money creation to finance spending either in the way Peter Warburton suggested or directly to finance government expenditure. He said that he favoured continuing with QE and to keep Base Rate where it is.

**Comment by Tim Congdon (*in absentia*)**

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

**Vote: Hold Bank Rate. No further QE**

**Bias: No bias**

My 'vote' is that policy must ensure that the annual rate of money growth is brought back down to under 5 per cent in the next nine months. Some above-target inflation now seems inevitable to me - I took this view in late 2006/early 2007 -and it was eventually vindicated, after much trauma, in 2010 etc. I hope inflation can be kept under 5% all through 2021 - 24, but - if we miss one or two quarters (which I expect) - life will go on. **No more QE please.** Interest rates can be kept down for the moment, to help the many borrowers who are in trouble through no fault of their own. I suspect they will need to rise in 2021, but the crucial point is to bring money growth back to under 5% at an annual rate. It looks as if a vaccine will be available in early 2021 - and life will be back to normal by, say, next autumn, but I don't expect any action to remove the excess money growth hump of spring & summer 2020.

**Comment by Patrick Minford (*in absentia*)**

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

**Vote: Hold Bank Rate. QE to be reversed.**

**Bias: to raise.**

My views have not changed from before. I think we need QE to be reversed in second half of year, to ensure long-maturity public debt is put into the markets at current low interest rates, to hold down taxpayer cost, and to withdraw inflation threat from Money growth. Once recovery has occurred, which I put from year end, I also expect interest rates to start rising. I suppose this is my 'bias' after agreeing to leave things alone right now. I think, contrary to most of the views here, that the recovery will be 'V-shaped', as so far the indicators have underlined. With the virus now in retreat and massive monetary loosening, I expect recovery in full by year end, with the monetary 'overhang' then creating a serious potential inflationary problem

**Any other business**

None

**Policy response**

1. There was unanimity that interest rates should be kept unchanged.
2. Three members expressed a bias to raise once the recovery takes hold
3. Five members said that there should be no further QE.
4. Two said that QE should be reversed once the recovery takes place.
5. Two members expressed support for money financing the deficit.

## **Date of next meeting**

13 October 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).