Shadow Monetary Policy Committee

13 April 2021

Shadow Monetary Policy Committee votes seven votes to two to hold Bank Rate in May and writes a letter to FT about the inflation risks of excessive growth in money supply stemming from QE.

At its April 2021 meeting, once again by video conferencing, the Shadow Monetary Policy (SMPC) voted by seven votes to two to hold the bank rate at 0.1%. As in the January meeting, there was unanimous agreement that the last round of QE announced in November last year was unnecessary and risked stoking inflation. All members at the meeting voted to sign a letter to the FT to that effect (attached).

Although there was a majority vote that interest rates should be kept unchanged, all agreed that they needed to be raised soon. The difference of opinion was about when rates should rise, before or after QE is curtailed. There was no consensus as to whether the second QE programme should be completed, stopped, or reversed. Some members wanted to continue the existing QE announced programme but finish it early, while others felt that no further QE should be undertaken.

Three members said that QE should be reversed now. The two members who voted to raise rates immediately and reduce QE felt that the risk of delay was greater than acting now. They thought that a modest rise now, to perhaps 0.5%, would send a signal that would embed current low inflation expectations and reduce the shock effect of a rate rise later on.

There was unanimity that the Debt Management Office (DMO) should lengthen the maturity of public sector debt to lock in the current low level of rates as much as possible.

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 13 April 2021 (Held by Video Conference)

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

Apologies: Roger Bootle

Chairman's comments: Andrew Lilico said that his term of the shared chairmanship has come to an end and he passed the chairmanship to Trevor Williams. Trevor Williams thanked Andrew Lilico for his chairmanship of the meetings and invited Julian Jessop to present his analysis of the economic and monetary situation.

The Agenda

Julian Jessop opened his presentation with the agenda. He said that he would give an update on Covid; move on to the global economy and the markets; then take a closer look at the UK, specifically the business surveys, then Brexit and trade; the labour market; and money and credit. Finally, he will make some concluding comments.

The Covid Update

55% of England's population have antibodies.

Julian Jessop said that the most important issue was the continued rapid roll-out of the vaccine programme in the USA and UK. Despite not having a national health system, the USA has rolled out the vaccine at the same pace as the UK. The UK and USA are the world leaders and the EU continues to lag behind. The benefits of the vaccine roll-out in the UK is being seen in the numbers. The second chart of the presentation slides shows that more than half the population have some form of immunity in the sense of having antibodies from having had Covid-19 previously or having being vaccinated. The government is therefore running out of excuses not to continue, or even to accelerate, the pace of the lifting of the lockdown. He said that the Covid backdrop in the UK and USA is looking increasingly favourable.

The global economy

Global PMI indices indicating strong rebound in economic activity.

Regarding the global economy, he said that he was a big fan of the PMI surveys because they are comprehensive and reasonably timely. He said that although the exact relationship with economic activity and prices is uncertain, particularly at exceptional times like this, the signals they are giving on activity and inflation are clear. There has been a strong rebound in the output index of the PMI and also a rapid increase in price pressures. He said that it was worth stressing that these price pressures are not just coming through energy or goods prices. He said that there has been a pick up in core inflation as well as services. This was also seen in the US CPI numbers that came out earlier today. A combination of stronger economic growth and increases in price pressure are coming through in the pipeline.

With regard to commodity prices; oil and copper prices have bounced back from post-covid lows. Although these have been higher in previous years, he said we know that they will feed through to higher headline inflation over the next 6 to 12 months. Another important indicator is the rise in global shipping costs. This is a global phenomenon although it seems that the UK has been hit harder. This partly Brexit related as some shipping companies have been reluctant to send ships to UK ports because of fears of being trapped in Customs queues. He said that this was only part of the explanation as there were also capacity problems with ports like Felixstowe. He said that shipping costs can account for between 5 and 10 per cent of final goods prices.

Broad money growth fastest in USA and UK

Finally he referred to the table of Broad Money Growth produced by the Institute of International Monetary Research. The figures show strong growth in the money supply particularly in the USA and UK. He said that there is good reason to believe that the figures will stay high for sometime. From experience, money growth is highly correlated with the growth in nominal income. Given the amount of pent-up demand and spare capacity, he said that there is a lot of scope for that growth in nominal income to be reflected in a combination of a rapid real economic growth and a pickup in inflation.

The latest IMF forecasts show the USA growing fast in 2021, which is twice as fast as what they were saying just a few months ago. The forecast of growth in the euro area is unchanged reflecting the slow rollout of the vaccine programme. The forecast for 2021 and 2022 for the UK was questioned by Andrew Lilico and Julian Jessop said that he thought that the IMF forecast was behind the curve and is likely to be revised up in line with other recent forecasts. Trevor Williams said that the third wave in Europe might negatively affect the UK GDP figures in the 4th quarter. Julian Jessop said that it was a definite downside risk, but he felt that trade in goods would be unaffected and services would continue as much of it is done online. Also, a continuation of travel restrictions will favour the UK holiday industry.

Finally, he said that breakeven inflation rates in the US Treasury market were suggesting a sustained period of inflation of 2½%, but that the market was being complacent about where the risks are.

UK near term outlook

…return to pre-pandemic level of output in quarter 3.

Julian Jessop said that he was bullish about the UK economy and that his forecast was for a return to the pre-pandemic level of output in the the third quarter of the year. Trevor Williams said that this would still leave UK output well below where it would have been in the absence of the crisis, even if it did occur. Julian agreed and said that the reason he was optimistic was because the economy has weathered the last two lockdowns reasonably well and there is an enormous amount of pent-up demand. Also the labour market is improving rapidly. He said that he struggled to find a business survey that was not incredibly bouyant. The Deloitte quarterly survey of CFOs and the latest PMI survey of the UK relative to other economies, show an encouraging picture. The surveys ask if economic conditions would improve in six months time, and given the weak starting point, he said that it would be astonishing if anyone said anything but 'yes'. Nonetheless, the message is clear that people are optimistic about business for the future. The UK is reporting the third strongest PMI of the major economies with the USA leading the way and Germany second.

He said that he tried to get a feel for the effects of staycations on the UK economy by looking at data available in 2019 for spending in UK by overseas residents and spending abroad from UK residents. The data shows that if UK residents spent their money at home and even allowing for no foreign spending in the UK that would still be several billion £ additional spending. There are capacity constraints in the holiday industry and that adds to the price pressure.

Brexit and UK trade

Exports recovery in February after initial fall in January

Julian Jessop said that there was a big fall in exports from the UK to the EU in January following the end of the transition period. But, the numbers that came out today show a pretty impressive recovery for the month of February, with the gap being closed a bit with exports to the rest of the world. He said that it looks like some of the initial disruption to trade has eased as people adjust to the new rules. Data from French Customs show a further recovery in March for UK exports to France. Other higher frequency data of port visits and freight volumes also indicate a recovery. However, there are still plenty of other problems. He said that wwe don't have a proper deal with the financial services sector and the performing arts but the goods sector at least appears to have recovered.

The survey evidence is mostly encouraging but mixed between surveys of small businesses and big businesses. The surveys of small businesses are more pessimistic while the Deloittes survey of big businesses suggest that CFOs expect Brexit problems to fade.

The labour markets

Hiring plans are greater….further rises in unemployment limited

Julian Jessop said that the PMIs for recruitment are showing a very strong recovery in March and that was even before the lockdown was lifted. People were clearly encouraged by the roadmap for the lifting of the lockdown. Other surveys were also showing that hiring plans are higher. Unemployment has also fallen slightly. With the economy rebounding faster than the ending of the furlough scheme he said that there is every expectation that further rises in unemployment will be limited. He said that unemployment is about 5 per cent and will peak at below 6 per cent.

UK Monetary Growth and Conclusions

Rapid growth of M4 holdings by PNFCs

Julian Jessop said that he had touched upon the UK monetary figurtes earlier in his presentation. The charts showed the annual rate of growth of M4X and the annualised three-month growth rate. He also showed the charts of the sector breakdown of M4 growth excluding intermediate OFCs, showing very rapid growth of M4 holdings by PNFCs. This highlighted that pent-up demand was not just from consumers but also businesses. He said that this meant a rapid growth in nominal GDP growth and both an increase in real GDP and inflation.

To conclude, Julian Jessop said that the global economic backdrop is strong, though Europe remains a concern. He said that he expected UK GDP to return to pre-Covid levels by Q3. He said that he expected unemployment to peak to below 6%, and inflation to be 2% from April onwards and head towards 3% and stabilise before falling back towards 2%.

Discussion

..inflation could rise to the 5% - 10% area…it is money growth

Trevor Williams thanked Julian Jessop for his presentation and invited comment from the Committee. Tim Congdon said that he disagreed with the second QE. There was no need for this extra boost to money growth. He said that he was very worried that inflation could rise to the 5 - 10% area and that it was heading in that direction in the USA. He said that there was a case for zero interest rates because of the damage to hotels and restaurants and the areospace industry and there will be some debts in those sectors if they had to pay higher interest rates. He said that there was a case for interest rates being zero till the second half of the year. Money growth has to be controlled by debt management by selling debt at the long end. He said that the company sector is swimming in cash and it is money growth that matters.

Is there a downside to abandoning QE?

Andrew Lilico questioned what the problem the second leg of QE is trying to solve? He said that is a question that needs to be addressed before we think about completing QE. He asked what problems would reversing it create? He said that since the expectation is for 7% GDP growth and rapid growth of money, what is the problem that the second QE is trying to solve? He said that a generous interpretation is that the outlook at the time the programme was announced was uncertain, but now the vaccination programme has done bettter than expected. The economy is going to open up with solid economic growth, so why do we need to continue with the QE? He asked what would be the downside for abandoning the QE programme?

Risks in delaying a tightening….?

Julian Jessop said that there was still uncertainty about exactly when QE would be completed – Q3 or Q4 of this year. He said that while he was confident in his forecast, he felt uncomfortable about doing something on the basis of a forecast. Problems might occur over the summer so there was a case for continuing the programme as planned. He said that he had a bias to tightening but the economy is still well below pre-covid levels and lots of uncertainties remain. Kent Matthews asked that given that the central forecast is for a rapid recovery and for a rise in inflation, what is the argument for not reversing QE now and raising base rate now? Julian Jessop said that while he remained confident about his forecast there were still huge uncertainties and that it might be better to wait a few months for confirmation. Andrew Lilico asked if there are risks in delaying a tightening. Julian Jessop said that given the weakness of the economy, it might still make sense to err on the side of making a mistake of being too loose rather than prematurely tightening.

Julian Jessop left the meeting at this point.

Bank must lock in low interest rates on long-term debt.

Patrick Minford said that he agreed with Tim Congdon about the need to stop further QE. He said that the Bank had to sell its long-dated debt as soon as possible to the private sector, so that it is not left in the public sector. What QE has done as pointed out by the OBR is to shorten the maturity of the outstanding public debt. This is going to more costly to service as interest rates rise. He said that the Bank should be locking-in these low interest rates on long term debt so to keep the cost of debt servicing low. He said that what Julian Jessop said about commodity prices was valid. There is going to be a huge commodity price explosion with all this money swilling around the global economy. Trevor Williams said that part of the commodity price rise was structural with the increase in electrification and the minerals needed for electric batteries. Patrick Minford said that this just exacerbates the demand problem. He said that the economy is moving towards the rapid expansionary phase and what would be destabilising is a sharp rise in inflation. He said that he would be forecasting inflation of 5% by the end of next year. The Biden package, and the Fed announcing that it will keep interest rates low, is an extremely aggressive intention combined with a sharp fiscal expansion, fuelling global demand. He said that the Bank needs to react soon to stop things getting worse on the inflation front.

Large public sector, growing social spending, inflation and low growth

Peter Warburton said that he agreed with much of what Patrick Minford and Tim Congdon said but he wanted to add a new element which is also common with Canada and America. Public attitudes to social spending are different as a result of the pandemic. There is strong pressure to increase welfare spending particularly on helath. Controlling the size of the public sector is going to be problematic both politically and economically. He said that there had been no serious attempt to justify the extra £150 billion of QE but the presumption in the market is that the Bank will just carry on. There will be a rude awakening when this tap is turned off. He said that he was worried about the long term growth effects of this large public sector. He said that the existing QE programme should be tapered to zero and the MPC should signal its readiness to raise rates. The Bank has agued that, as soon as it sees inflation, it will hit it on the head, but this will be much too late. He said that in 2023 and 2024, stubbornly high inflation could coincide with a stagnant economy.

Inflation rising to 4 – 5% means interest rates rising 6-7%...

Phillip Booth said that he thought Julian Jessop was taking a one-sided view of policy risks. He said that a forecast is based on the best information available at the time and therefore should be acted on. The risk of not doing so is that if inflation rises to 4 or 5 percent, then interest rates will have to rise to 6 or 7 percent to reverse it. That is an order of magnitude greater if inflation is allowed to get out of control and you have to deal with it one year to 18 months time. On a second point he said that supply side problems could not be dealt with by expanding the money supply or lowering interest rate, and covid is basically a supply-side problem. He said that this was reminescent of the problem of the 1970s that people thought they could solve supply-side problems by printing money. A third point that is also 1970s related is the ressurection of the language of outdated industrial policy relating to repatriating supply chains and government sponsored research. That type of rhetoric, if followed through, will certainly reduce the growth rate. He said that regarding Tim Congdon's point that interest rates be kept low to ease the problems of bad debt through default would be much worse if interest rates had to rise to 4-5% than if it were raised to ½% now. He said that interest rates should be raised now.

Viability of some businesses will not be altered by low interest rates…

Andrew Lilico said that he was bullish about the scope for real economic growth. He said that the UK is in a good place in relation to the vaccine programme and will come out faster than many other places in the world. This places the UK in a good position in the post pandemic period for exports and investment. Brexit has worked out well and so the real economic outlook is quite strong. He said that QE is not solving any problems any more. There will be a period of bankruptcies in the recovery phase. The business models of the hospitality sector is probably broken as fewer people will go into the city centre in a post-covid world. The viability of some business will not be altered by low interest rates. He said that the QE programme should come to an end. He said that his ordering of the policy would be to end the QE programme. Then reverse QE over the horizon so that 10 and 20 year bond yields are brought back towards zero. An extended period of them being negative has not been helpful. Once getting them to zero, he said that is when interest rates should be raised.

Bank appears unconcerned about the effects of QE on asset prices.

Juan Castaneda said that one of the things the Bank has stated is that QE is primarily targeted at interest rates. The Bank does not appear to be concerned about the effect of QE on asset prices and the excess in money holdings by households, non-financial, and financial companies. He said that he agreed with Patrick Minford and Tim Congdon that this will have an effect on inflation. He said that there are early signals of inflation coming later in the year. A 15% growth in broad money is not compatible with any reasonable measure of price stability. Interest rates should remain low, as there are benefits to the business sector in these extraordinary times. He said that the base rate should stay on hold until the lockdown is lifted in June and to halt QE. He said QE should be stopped; rather than immediately, the Bank should announce the stop in asset purchases by the end of May. This is so that the change in the Bank's QE policy is more gradual and can be anticipated by markets.

Credit conditions will tighten, and lending rates will rise….

Trevor Williams said that banks were flush with deposits but that will not be translated one-to-one into lending. Partly because they are afraid of defaults and insolvencies. He said that credit conditions will tighten and that is already evident in the numbers reported by companies about bank credit. This will exacerbate bankruptcies and failures and may slow growth to some extent. Some of the loans from government will not be repaid. Indeed, some of the rise in deposits held by households and businesses are from direct government transfers to support them during the pandemic. He said that government typically are reluctant to tighten in a recovery and will be in a situation of too little too late. He said that QE should be stopped but rate rises should be delayed. Market rates will do the tightening without the authorities having to act. Long-term rates will rise because of the inflation backdrop and the stopping of QE. Lending rates will rise because credit conditions will tighten. Effectively, the private sector will be doing the monetary tightening for the authorities. He said that he agreed that the maturity of government debt should be lengthend.

Long-term bond rates will respond to a small rise in base rate now as a signal of future rate rises.

Kent Matthews said that he was less optimistic with the view that halting and then reversing QE will raise long term interest rates significantly. Bond yields have already risen and the upward sloping yield curve that others have mentioned is already evident. The markets will react more forcefully when they see the Bank act and as so far they think that the Bank will not change rates for a while yet. They do not expect a rate rise. If rates rise sharply in response to inflation later rather than sooner, all the things that others here have mentioned such as insolvencies and failures will surely happen because the rate rise will be unexpected. Much better to signal that rates are on the rise with a small rise now. The tightening will then come through from the exchange rate as well the money market rates. Long-term rates are more likely to respond to expectations of further rises in short rates than just halting QE

Votes in order rather than alphabetically.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Hold Bank Rate. Stop QE.
Bias: to raise and to reverse QE.

Patrick Minford said that the Bank needs to sell long-term debt and lock in the low interest rates. Rates should remain on hold for now with a bias to rise and QE stopped.

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)
Vote: Hold Bank Rate
Bias: No further QE

Tim Congdon said that he is in favour of stopping QE immediately. Debt sales at the long end should be managed to target a growth rate of broad money of about 5%. Interest rates rises should be postponed until next year to avoid defaults that could trigger a spate of bad loans that would have a disproportionate effect on the economy.

Comment by Julian Jessop

(Independent Economist)
Vote: Hold Bank Rate. Continue QE for now.
Bias: To tighten.

Julian Jessop said that there should be no change to interest rates and that QE should be continued as announced, at least for a few months. But he had a bias towards tightening, with QE ending sooner and Bank rate raised to 0.5% later in the year.

Comment by Juan Castaneda

(Institute of International Monetary Research, University of Buckingham)
Vote: Hold Bank Rate
Bias: No further QE

Juan Castaneda said that he voted to keep rates on hold and to stop QE. However, rather than stop QE immediately he proposed that the Bank announce that asset purchases will end in May. This is so that the Bank's action is gradual and easily anticipated by the market.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To Hold Bank Rate. Taper QE.
Bias: bias to raise rate

Peter Warburton said that he would like the existing QE programme to be tapered out and signal a willingness to start raising rates. He said that QE should be tapered to zero first and rates to rise in the summer.

Comment by Phillip Booth

(St Marys University)
Vote: To raise Bank Rate.
Bias: To reverse QE

Phillip Booth said that the dangers of not raising rates are now greater than raising them. He said a rise to 0.5% is warranted.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: Hold Bank Rate
Bias: Bias to reverse QE and selling down-term debt but lengthen the maturity.

Trevor Williams said that there should be a cessation of QE and interest rates should be kept on hold until 2022 to see how the economy performs with bankruptcies and insolvencies.

Comment by Andrew Lilico

(Europe Economics)
Vote: To Hold Bank Rate. To end QE.
Bias: To reverse QE after the end of lockdown. To raise rates.

Andrew Lilico said that he would like to see a three-stage timed policy. First, hold rates and hold QE. Second, reverse QE to push yields up to above zero and then third, begin the process of raising rates. He said that this last stage may be some way further down the line.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate.
Bias: to reverse QE gradually and a bias to raise rates in small steps.

Kent Matthews said that the market needed a clear signal now and that raising rates later could cause more harm to the economy because it would be unexpected. A small rise in rates now would do little damage to cash flow of firms and give a much-needed signal to financial markets that rates are on the rise. The expectation of further rises in short rates will result in longer term bond yields responding.

Any other business

The committee discussed the drafting of a letter to the FT led by Tim Congdon criticising the second tranche of QE. Trevor Williams said that he would coordinate the letter for members to comment and sign.

Policy response

1. There was a majority vote that interest rates should be kept unchanged. Two members voted to raise rates to 0.5% immediately.
2. There was unanimity that interest rates should be raised soon.
3. There was no consensus as to whether the second QE programme should be completed, stopped, or reversed. Some members wanted the continuation of the existing announced programme but finishing early, while others felt that no further QE should be undertaken. Three members said that QE should be reversed now.
4. There was unanimity that the Debt Management Office should lengthen the maturity of public sector debt to lock in low rates as much as possible.

Date of next meeting

13 July 2021.

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 quarterly meeting held 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 (TW Consultancy, University of Derby, St Mary's University). 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), John

Greenwood (Invesco Asset Management), Julian Jessop (Independent Economist), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff 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).