
IEA Shadow Monetary Policy Committee

May 2014



Institute of
Economic Affairs

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Shadow Monetary Policy Committee votes five/four to raise Bank Rate by ¼% in May

At its meeting of Tuesday 15th April, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) recommended by five votes to four that Bank Rate should be raised ¼% on Thursday 8th May, including four votes for a rise of ½%.

Those urging a rate increase offered a variety of rationales. Some expressed the view that it would be better to start rate rises when the economy is going well and raising rates can be seen by consumers and investors as a sign of economic improvement than to wait until inflation or other problems force a rate rise which would then be regarded negatively. Others said that low rates are encouraging a misallocation of capital between firms and encouraging policymakers to use additional regulation to discipline economic behaviours that would be better disciplined by the price mechanism and market forces if interest rates were a little higher. Others suggested that rapid rises in house prices indicated that sentiment is in danger of becoming carried away and a “shot across the bows” is needed.

Some of those urging rates remain unchanged noted that inflation is low, output remains depressed below peak, and that we are still early in recovery. Factors such as rapid house price rises should be seen at this stage as corrections to past falls rather than as signs of excess. Credit growth remains lower and the banking sector remains fragile. One of those voting for a hold, however, expressed the concern that large UK asset price movements might reflect higher monetary growth in emerging markets than is yet visible in the data, and said that if rapid house price rises in the UK continue he might be inclined to recommend a rate rise within the next few months.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. 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. The next two SMPC e-mail polls will be released on the Sundays of 1st June and 6th July, respectively.

Minutes of the meeting of 15th April 2014

Attendance: Philip Booth (IEA Observer), Tim Congdon, Jamie Dannhauser, John Greenwood, Andrew Lilico (Chairman), Kent Matthews (Secretary), Patrick Minford, David B Smith, Akos Valentinyi, Trevor Williams.

Apologies: Roger Bootle, Anthony J Evans, Graeme Leach, David H Smith (Sunday Times observer), Peter Warburton, Mike Wickens.

Retiring Chairman's Valedictory Comments

David B Smith, the retiring Chairman, thanked all the members of the IEA's shadow committee who had engaged with him in the successful production of the monthly SMPC reports over the past eleven years but especially those who had submitted their copy on time and without requiring reminders. He also recorded his gratitude to Lombard Street Research, particularly Pippa Courtney Sutton and her successor Tom Crew, who had put out the long stream of monthly SMPC reports so efficiently. David next thanked Rosa Gallo at Economic Perspectives, who had done an impeccable job of proof reading, often against tight deadlines. Philip Booth expressed the thanks of the members for David B Smith's long chairmanship and presented him a certificate of appreciation signed by the members along with a cheque made out to his chosen charity 'Newborns Vietnam'. David B Smith thanked the members for their generosity. He added that, in case anyone was wondering about his choice of charity, it was because one of his daughters in law came from Da Nang where the charity operated. David B Smith then passed on the chairmanship to Andrew Lilico.

New Chairman's Comments

Andrew Lilico said that he did not propose to make any radical changes to the organisation and suggested that the proceedings move swiftly on to the monetary situation. He called on Akos Valentinyi to make his presentation.

Monetary situation

Akos Valentinyi referred to the circulated charts and began with the world situation. Turning to the chart of world economic growth and its decomposition he said that the world economy is picking up speed but there is a lot of heterogeneity in the contribution and what is striking is that in 2014 Western Europe is expected to make a strong positive contribution. The USA is expected to grow by more than 2.5%, offsetting some of the slow-down from China. Oil prices have stabilised and world inflation is likely to stay around 3%. The Ifo World Economic Survey indicates improvements in the USA and Western Europe but again in the case of Europe there are large differences. While the EU is expected to grow moderately, Italy and France are stagnating, but UK and Eastern Europe

Europe growing moderately and the European Keynesian experiment in reverse

show signs of improvement. The chart of the changes in the fiscal pattern in the EU shows that the great Keynesian experiment that was tried in the early stages of the recession has been reversed.

Inflation lower and inflation expectations anchored

Turning to the domestic economy, UK inflation is declining and even during the time after the recession when inflation was on an upward trend Tim Congdon had correctly predicted that inflation would fall. The figures show that both goods and services inflation is declining. Producer prices in particular show a sharp decline in inflation. The data shows no evidence of inflationary pressure. The Bank of England survey of inflation expectations show a consistent pattern of expected future inflation lower than perceived past inflation which indicates an anchoring of inflation expectations. Labour productivity growth is slower than the rate of increase in unit labour costs which does not portend well for the supply side.

Falling savings rate in this stage of the cycle indicates rising household demand

On the demand side, exports are growing well and also household spending is growing steadily but investment remains sluggish. Tim Congdon noted that net exports are still weak. Akos Valentinyi contended that the reason for focussing on exports is to reflect the growth of external demand. Regarding the components of consumption, Akos Valentinyi referred to the charts showing spending on durables growing strongly. Jamie Dannhauser informed the group that the price of many household electrical goods such as flat screen TVs had fallen suggesting a hedonic price effect. Akos Valentinyi observed that the savings rate rose in the early phase of the crisis but it has fallen recently, indicating growing household demand.

ONS revisions to erase the double-dip....

Turning to the supply side, the service industries are showing robust growth. The construction sector remains a problem and manufacturing, which had seen earlier signs of recovery, may have slowed. The growth in exports has been largely non-financial services and IT services but there has also been a recovery in precision equipment. The double-dip, soon to be erased by Office for National Statistics (ONS) revisions, was largely the result of North Sea oil production and manufacturing.

...but unemployment continues to fall and will breach the magic 7% figure

The decomposition of productivity shows that some sectors have improved over the 2005 base with manufacturing above services but construction lagging behind. Unemployment is falling and likely to breach the magic 7% figure. The Beveridge Curve for 2001-2013 shows a structural shift from 2010. John Greenwood said that a similar pattern can be seen for the USA. Shifts in the Beveridge curve could be a permanent or temporary effect, and might indicate a growing skills mismatch. Vacancies are going unfilled, perhaps because of skills shortages.

Pattern of M4 growth is not like any other recession experienced by the economy

Figures for the money stock show that the whole dynamic of this variable has changed markedly. M4 has slowed down like no other recession. Charts showing the growth of nominal GDP against M4 growth, isolating outliers for the two periods 1963-1999 and 2000-2013, show that the responsiveness of nominal GDP growth to money growth has weakened in the latter period. Andrew Lilico said that the distortions to the M4 series presented made

the charts difficult to interpret and that an alternative series might give a clearer indication.

UK showing robust growth but weakness remains... Monetary figures indicate fragility

Akos Valentinyi summarised his presentation by stating that the UK economy shows signs of robust growth but weaknesses remain on the supply side. Productivity remains a problem as does the growth of bank credit and M4 which continue to indicate a fragile recovery. His recommendation is that the economy is in a strong enough position to withstand a rise in interest rates.

Discussion

Natural rate of interest changed because of the recession...

Andrew Lilico thanked Akos Valentinyi for his presentation. He began by challenging Akos Valentinyi to provide a credit channel explanation of growth in 2013 alongside a declining fiscal deficit. Specifically, Andrew asked, if the policy recommendation is a rise in the Bank Rate, what in particular guides this recommendation and suggests how large any such rise should be? Kent Matthews said that the credit channel view would concentrate on the dearth of private sector investment and the failure of credit growth to reach the sectors that are productive. According to the credit channel view the recovery is not sustainable without a supply-side response from increased investment generated by higher credit growth. Jamie Dannhauser asked if the natural rate of interest has fallen because of the recession. He said that IMF research suggests that there has been a fall in the equilibrium rate of interest. David B Smith said that demographics played an important, but often unduly neglected, part in the determination of the long-term growth rate and the natural rate of interest. Countries with relatively rapid increases in the population of working age generally would have faster economic growth and higher real interest rates, other things being equal. Andrew Lilico added that changes to the working age population affects the growth of potential Gross Domestic Product (GDP) and said that the natural rate of interest fell in the mid-2000s but it is now rising. If the future growth rate is to rise, then it is likely that the equilibrium real rate of interest will also be higher.

Progressive liberalisation of the banking sector is being reversed with increasing re-regulation

Andrew Lilico said that he was optimistic about long term growth. The reason is the fall in government consumption, and the increase in the retirement age that will lead to a rise in the labour force. Also the financial sector which had been impeded is on the point of recovery. Tim Congdon repeated his view that 2008 will represent a watershed in the history of the UK banking system. He contended that progressive liberalisation was being reversed with increased re-regulation which has led the banks to slow the growth of their balance sheets. He posed the question: has the pattern changed? It appears not. On the contrary, there is quite a lot more regulation coming through. However, there has been some positive growth of broad money and asset prices have recovered. The question for him was why there is a bubble in London house prices. Much of this activity is being driven by foreign cash buyers. He wondered whether that this

Other opinions and a call for votes

might appear in data on foreign currency deposits. While financial sector exports are lower than in 2008, other services have been growing strongly, contributing to buoyancy in the London economy. Trevor Williams asserted that only around 15% of buyers are foreign but the real problem is the lack of supply.

As Patrick Minford had to leave the meeting early he asked for his vote to be taken at this stage. He said that he agreed with Akos that the economy was improving and that it was imperative that monetary policy return to normalcy and that he favoured a 50 basis point rise in rates and Quantitative Easing (QE) be reversed. Andrew Lilico asked the committee for other opinions and a general call for votes.

Votes

Comment by Tim Congdon

(International Monetary Research)

Vote: Hold Bank Rate and pause QE

Bias: To raise interest rates

Inflation should be expected to be low, but if UK house price rises persist an interest rate rise might be needed

Tim Congdon said that inflation prospects are good in all the main economies. Indeed, the prospect is for deflation in several countries in late 2014. Since that will justify monetary policy easing, his surmise was that 2015 will be a strong (or at least an above-trend) year for world activity. However, he expressed the concern that large UK asset price movements might reflect higher monetary growth in emerging markets (especially those in which Basel rules are not enforced) than is yet visible in the data, and said that although it remains too early to recommend a rate rise at this stage, if rapid house price rises in the UK continue he might be inclined to recommend a rate rise within the next few months.

Comment by Jamie Dannhauser

(Ruffer)

Vote: Hold Bank Rate and QE

Bias: Neutral

UK should avoid the rise in sterling that comes with a rate rise at this stage of the recovery

Jamie Dannhauser said that much of the debate about the equilibrium interest rate was confused, but that on balance he believed that it was lower than pre-crisis. He accepted that construction activity had recently been weak but business services excluding finance were growing rapidly. His concern is the sustainability of this growth rate beyond the near-term. Global inflation is moderate. The major downside risk to the UK economy lies in the external sector. He said that he views the UK as a small open economy. The Eurozone problem is not as bad as it was but he remain worried over how the UK economy would react to a rise in domestic interest

A UK rate rise should wait until the world economy is stronger

rates. He said there was a good chance of further currency appreciation if the Bank moved ahead of the US Federal Reserve, as some Shadow MPC members were suggesting. He said the economy was not strong enough, or sufficiently re-balanced, to warrant a rise in rates at this stage.

What would make him vote for a rate rise are signs of a more sustainable global recovery: a stronger US economy, greater evidence of a supply-side adjustment in the euro economies and a clear revival in Japanese domestic spending. He was also concerned about the possibility of a more abrupt slowdown in Chinese growth, and the pass-through to other emerging economies, which for much of the last few years had been the main source of global demand at the margin. It was therefore too early to start tightening. He voted to keep interest rates on hold with no bias on QE.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold

Bias: Neutral

Distinguish between a bubble caused by low interest rates and one caused by credit growth

John Greenwood said that the economy has experienced one year of good growth and therefore it is too early to reverse policy. House prices are rising but there is a need to distinguish between a bubble caused by very low interest rates and one caused by the growth in credit. The scale of speculative borrowing is small and this would soon evaporate once rates start to rise. However, the overwhelming story is that credit aggregates and broad money are not growing so this is not a bubble that the authorities should be worried about. Large sections of the economy are weak. The time to worry is when M4 starts to grow in the 8-9% a year range. This is just a bounce back in the economy. He said that interest rates should stay on hold with no need to unwind QE.billion per quarter starting now.

Comment by Andrew Lilico

(Europe Economics, IEA)

Vote: Raise Bank Rate by ½%

Bias: To raise further; QE neutral

Better to raise rates in good conditions

Andrew Lilico said that the economy was still very weak and policy should remain extremely accommodative. But the case for emergency levels of accommodation had lapsed. Moreover, it is better to raise rates under conditions when there is nothing bad happening to the economy, so that this can be interpreted as a positive sign, rather than a negative one from being reactive (e.g. to rising inflation or excessive lending growth) – this would reduce the risk that interest rate rises would be disruptive. The need is to move rates earlier rather than later.

The interest rate is a relative price and it is failing to signal the true price of future consumption

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%

Bias: To raise further; QE neutral

Kent Matthews said that the rate of interest is not just a macroeconomic tool but also the relative price by which current consumption is traded for future consumption. It is also the rate which benchmarks investment projects that should be funded from those that should not. While he accepted that there are macroeconomic risks in raising the rate of interest the microeconomic distortions of a low rate of interest has created financial repression and a misallocation of resources that need to be reversed to encourage a supply-side response. In the current situation the flow of funds from poor investments to good investments is not occurring because the banks are failing to act as efficient financial intermediaries. There are a myriad of reasons for this including the increase in regulation but principally, low interest rates have created an environment where banks continue to lend to firms that should be allowed to fail diverting funds from firms that should be funded. He also believed that the recovery was fragile but this fragility is a supply-side phenomenon that can only be addressed through the gradual return to normality where the real rate of interest signals the true price of future consumption. He said that he did not know whether the equilibrium real rate had fallen as a result of the recession but he was sure that it is higher than what it is now. He said that he could not believe that companies that have made medium term investment plans would be put off by a small rise in interest rates even if this signalled a further rise. Investment plans are forward looking and companies must have factored in a rise in rates sometime in the future anyway and therefore he voted to raise interest rates by ¼% with a bias to further increases and no QE.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½% and reverse QE

Bias: To raise further

Bank of England planning to use regulation to control house prices rather than interest rates

Patrick Minford said that the economy was recovering and that it is time to reverse policy on interest rates. Rather than use the rate of interest to slow down the rate of house price inflation, the Bank of England has constituted committees to design regulations to control house prices. Further regulation is not what the market needs.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)

Vote: Raise Bank Rate by ½%

Bias: Avoid negative regulatory shocks; raise Bank Rate to 2% to 2½%, and gradually run off QE

Economy will look a lot stronger after ONS revisions

David B Smith said that he was surprised that there had not been more discussion about the forthcoming rebasing of the UK national accounts in late June. The somewhat limited information released by the ONS so far suggested that this will be one of the biggest ever upheavals to the way that the economy is measured and one that could substantially change the perceived view of Britain's economic performance in recent years. The available information suggested that the re-defined ONS figures will make UK economic performance look noticeably stronger since the onset of the recession, possibly eliminating the alleged output gap that had been used to justify maintaining Bank Rate at ½%. He added that the ONS house price figures released that morning (15th April) almost justified a rate hike on their own, with the UK year-on-year increase accelerating from 6.8% in January to 9.1% in February and the equivalent figures for London picking up from 13.2% to 17.7%. He remained concerned by the general deceleration in M4ex broad money since the summer of 2013. However, the latest data showed an increase in the annual growth of M4ex from 3.1% in January to 3.7% in February, so it was conceivable that the pace of money creation was quickening again.

Average Earnings/CPI comparison overstates pressure on living standards because it ignores direct tax cuts

David B Smith added that that morning's consumer price data included the fact that the tax and price index (TPI) had risen by a modest 1.4% in the year to March, compared with the 1.7% increase in the year to February. The TPI corrects Retail Prices Index (RPI) inflation, which was 2.5% in the year to March, for changes in the burden of direct taxation. It would almost certainly not be statistically correct to apply the 0.9 percentage point gap between the RPI and the TPI to the 1.6% annual rise in the CPI in the year to March to give a 'CPI/TPI' annual rise of 0.7%. Nevertheless, it was possible that the pressure on employees' living standards was being overstated by the widely employed comparison of average earnings with the CPI, which ignored the rise in tax thresholds. He thought that the so-called NAIRU in the UK (i.e., the unemployment level at which inflation tended to accelerate) was being reduced by benefit reforms and other labour supply policies. Furthermore, he welcomed the fact that Mr Osborne was starting to look at the supply-side benefits from tax cuts at long last. The latest OECD *Economic Outlook* suggested that there would be a substantial reduction in the ratio of aggregate OECD general government expenditure to GDP next year, which should have the beneficial effect of 'crowding in' private activity. However, he was sufficiently concerned about the signs of speculative excess building up in the UK property market (and elsewhere in financial markets) to believe that a warning shot across the bows was necessary to manage speculators' animal spirits. David B Smith voted to raise Bank Rate by ½% in May, with a bias towards a series of phased, modest increases subsequently.

Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½% and no unwinding of QE

Bias: To raise Bank Rate

The downside risk of a rate rise is not as large as the downside risks of postponing rate rise

Akos Valentinyi said there were three reasons for raising rates and that the situation demanded a careful assessment of the risks. The risks of a rate rise had to be balanced against the downside risk of not raising rates. First, the UK has shown robust signs of growth. The downside risks from a rise in rates are not very large but postponing a rise creates greater risks. Second, insolvency rates have fallen and are now lower than the previous recession. A rate rise will have a forward looking effect by signalling a return to normality. Third, asset price rises are signalling more than a bounce back. He voted to raise rates by ½% with no unwinding of QE presently.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking, University of Derby, Vice Chairman)

Vote: Hold; no change in QE

Bias: No change

A bounce should not be mistaken for a permanent rise in growth

Trevor Williams said that he agreed with Jamie Dannhauser and John Greenwood. The health of the financial sector is much misunderstood. The banks are engaged in a search for yield and remain vulnerable to economic slowdown or any faltering of the recovery. Raising rates will not solve this problem. The economy is still smaller than it was in 2008. Unemployment is still high. Investment has not risen and a rise in rates will kill the recovery plans of companies. A bounce in the economy should not be mistaken for a permanent rise in growth. A rise in the rate will prick the London bubble but outside London house prices are not rising as rapidly. Unaffordability will be the reason why house prices inflation in London will be tamed. The Financial Policy Committee is designing new regulations to curb the housing market and affordability will figure strongly in the future growth in house prices. He voted for no change in rates and no change in QE.

Policy response

1. On a vote of five to four, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in May. The other four members wished to hold.
2. There was only modest disagreement amongst the rate hikers as to the precise extent to which rates should rise. Four voted for an immediate rise of $\frac{1}{2}\%$ but one member wanted a more modest rate rise of $\frac{1}{4}\%$.
3. All those who voted to raise rates expressed a bias to raise rates further. One of those who voted to hold rates had a bias to increase rates in the near future.

Date of next meeting

Tuesday 15 July 2014

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 in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is Andrew Lilico (Europe Economics, IEA). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Patrick Minford (Cardiff Business School, Cardiff University), David B Smith (Beacon Economic Forecasting and University of Derby), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Commercial Banking and University of Derby). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.



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