IEA Shadow Monetary Policy Committee

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Institute of Economic Affairs

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Shadow Monetary Policy Committee votes five/four to hold Bank Rate in February

In a significant reversal of its longstanding recommendation to raise rates, the Shadow MPC has voted to keep rates on hold. It should be emphasized that the driver of this shift was not a change in the personnel voting. Instead, three members that had, at previous physical meetings, supported raising rates changed their votes to support a hold.

Those favouring a hold included members that have been long-standing opponents of raising rates, arguing that there is no inflationary pressure and that the recovery is not sufficiently secure that the economy could tolerate rate rises. To this group were added three new votes for a hold. Two of these argued that raising rates at a time when inflation is far below target was incompatible with the inflation targeting regime. A third felt that political and geopolitical uncertainties are sufficiently high to warrant a temporary delay in rate rises.

Those advocating raising rates emphasized that the strategy of maintaining near-zero rates has been damaging to real economic growth, to productivity growth, to the pressure to achieve a sustainable fiscal position and to longer-term financial stability. There was an excuse for setting rates near zero in 2008/09, but subsequently they have been kept at that level for far too long, the taboo of rate rises should be broken and normalisation is long overdue.

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 March and 5th April 2015, respectively.

Minutes of the meeting of 13 January 2015

Attendance: Philip Booth, Anthony J Evans, Andrew Lilico (Chairman), Kent Matthews (Secretary), Patrick Minford, David B Smith, Peter Warburton, Trevor Williams.

Apologies: None received

Chairman's comments

The Chairman requested that the committee discuss the frequency of future e-poll recommendations in the light of the announced change in the actual MPC frequency of meeting in 2016. The meeting agreed to continue with the monthly poll and review the e-poll frequency at the October 2015 physical meeting. The committee also agreed that future physical meetings will devote some time to issues of common interest other than the setting of Bank Rate. Furthermore, there is to be a change in the required format of voting whereby a comment is not always required. *(That approach is adopted from these minutes on.)*

He then invited David B Smith to present his analysis of the global and domestic trends.

International Background

OECD Broad money consistent with low steady inflation and trend growth rate

David B Smith distributed his briefing paper (this is available from xxxbeaconxxx@btinternet.com) and commented that one running theme of his presentation was the continual changes to, and occasional disappearance of, previously well-established domestic, international and financial-market data. The general picture for the global economy was one of disappointing GDP growth but with some mature economies doing well. Global industrial production fared a little better but was slowing in the Eurozone area. Inflation in the OECD was also slowing. Official figures for broad money in the OECD area are no longer published but unofficial figures were consistent with stable low inflation and trend growth.

Various developments in currencies and commodity prices, especially oil

On the currency and commodity markets, the Yen had depreciated by 7.6% and the dollar appreciated by 8.1% since the last meeting of the SMPC. The Euro had weakened by 1.5% and sterling stabilised on the trade weighted basis. Oil prices had fallen by more than 40% to $50 a barrel (it was mentioned that oil had fallen to $47 that morning) and non-oil commodity prices had fallen 2.8% since October.

UK broad money figures signalling a slowdown

There had been a worrying deceleration in broad money M4ex in recent months, possibly portending a slowdown in the economy. Headline M4 lending had contracted signalling the effects of regulatory overkill on the growth of bank assets. However, the divisia monetary aggregates indicated a more buoyant outlook for the household sector and non-financial corporations.

Worrying statistics on the size and trend in current account deficit

The revisions to the UK statistics announced on 23rd December had invalidated significant parts of the Autumn Statement and were inconsistent with the Office for Budget Responsibility (OBR) projections. The constant adjustments to the data had also made the job of forecasting hugely difficult. Components of domestic demand showed a mixed picture of modest and robust growth. Household consumption was up 2.4% yearly in the third quarter, while gross domestic fixed capital formation was up 6.4% in the same period. Services recorded strong growth as did manufacturing in November. The main worry was the current account deficit which on revised figures was £3.19 billion higher than earlier figures. Both the size and deteriorating trend were cause for concern.

Labour market tightening but unit labour costs flattened

Employment statistics suggested that the labour market was tightening. However, average earnings (excluding bonuses) rose only 1.8% in the year to October with the private sector recording a rise of 2.3% and the public sector only 0.5%. Productivity growth measured by output per hour remained flat in the third quarter with only a 0.3% rise year-on-year. Unit labour costs had flattened in the first three quarters of the year representing good news for those who believe that inflation is principally determined by earnings growth.

Prospects are a for a long period of low inflation and low growth

November producer input prices continued to show the sharp decline of recent month contributing to the modest fall in producer output prices. CPI inflation eased to an annual rate of 0.5% in December and headline RPI inflation fell from 2.0% to 1.6% in December. The old RPIX measure also showed a slight fall to 1.2% on the year in December. House prices were indicating a modest slowing but with strong regional differences. Global and domestic uncertainties along with the numerous data changes domestically and internationally make forecasting particularly hazardous in this environment. Conditions could become very different after the May election for the MPC and any decision they make now will have an impact only after the election. The forecast is for a long period of low inflation with growth converging to a trend rate of 1¾% a year. The slow reduction in the fiscal deficit coupled with the deteriorating outlook for the current account raises questions about how the UK is to meet its twin deficits.

Discussion

Andrew Lilico thanked David B Smith and since Patrick Minford had to leave early he asked him for his comments before opening up the meeting to a general discussion.

Consistency and relevance of national statistics

Patrick Minford said that he believed one should not exaggerate the significance of difficulties with recent GDP and other real economy data since they have long been known to be flawed. Andrew Lilico said that this is all the more reason why more attention should be paid to the monetary aggregates. David B Smith said that the ONS was more concerned with satisfying the requirements of Eurostat than producing statistics of relevance to UK users. Trevor Williams said that the statistics are important because of the way they are interpreted for business confidence.

Monetary policy must be normalised

Patrick Minford said that the Bank continues with an unsustainable monetary policy. The existing monetary aggregates provide poor signals. Firms were substituting for alternative means of credit ranging from crowd funding to trade credit. The current policy of the Bank of accumulating the debt of the government was highly risky and that debt could turn out to be worth a lot less if a Labour government is elected. He said that monetary policy needs to be normalised. Fiscal policy is the key to inflation through its effect on expectations and the exchange rate. The rate of interest needs to get back to a norm of around 2-3% and the Bank needs to reverse QE and start the process of removing the mountain of government debt on its balance sheet.

Three key issues for discussion

Andrew Lilico said that the meeting should address three issues.

- Europe, political risk and the implications for financial risk.
- Deflation in the eurozone.
- UK money supply

Germany expected to shoulder an unreasonable burden

He asked David B Smith to comment on the implications of political risk in Europe in his forecast. David B Smith said Greece will probably exit the Eurozone but its relatively small size meant that this development was digestible and need not threaten the long-term survival of the rest of the monetary union. Andrew Lilico asked if deflation will be driven by oil prices alone. David B Smith said that deflation can have a positive a ‘Pigou effect’ – i.e., it raised the real purchasing power represented by the existing stock of money – but there is a negative effect from the rise in the real interest rate. The net effect was correspondingly uncertain. He said that regarding Europe, Germany has been asked to shoulder an unreasonable burden. Germany faces acute demographic problems which will make it difficult for it to continue with its current burden in Europe. Trevor Williams said that falling yields are usually interpreted as stimulatory so why is a steady-state of 1¾% justified? David B Smith said that his model allows for a Ricardian Equivalence effect. Firms are holding fire on investment decisions. He added that much of the policy discussion in the past had been rendered irrelevant by revisions to the data.

Why is monetary growth so low?

Andrew Lilico said that lack of monetary growth, despite the stronger growth in the real economy, is a mystery. Trevor Williams said that it was the nature of the recovery. The corporate sector is repaying debt and households are not borrowing. Productivity is stagnant, so GDP growth is being generated by employment growth.

Is the labour market tightening?

Andrew Lilico also noted earlier remarks about tightening in the labour market and asked what the evidence for such a tightening labour market is. Peter Warburton said that unskilled workers have seen major reductions in real wages but wage inflation is on the way back in pockets of the labour market. Trevor Williams said that because of low productivity growth, the growth in GDP is unsustainable.

The changing nature of UK investment abroad versus foreign investment into the UK

Peter Warburton said that national statistics has revealed the interesting pattern that up to 2007 Net National Product (NNP) had been growing faster than GDP. Since 2009, this has been reversed. The economy is sufficiently flexible for low-cost businesses to be set up by foreigners and to remit the earnings stream abroad. A higher proportion of domestic assets are now held by foreigners. Policymakers should not focus solely upon GDP but should also take account of such portfolio effects — which were not favouring UK citizens as much, at present, as in the recent past.

Andrew Lilico called the meeting to order and asked for votes to be cast.

Vote by Philip Booth

(Institute of Economic Affairs and Cass Business School)
Vote: Raise Bank Rate ½%. No further QE.
Bias: To raise, and as broad money rises to withdraw QE.

Vote and Comment by Anthony J Evans

(ESCP Europe)
Vote: HOLD
Bias: To hold QE

Missed window of opportunity to normalise monetary policy

Anthony J Evans said that the window of opportunity to raise rates has passed. Growth is not taking-off as money supply data is weak. Therefore there is no overwhelming reason to tighten. Inflation is below the target but the effect of a positive global productivity shock cannot be celebrated because of the inflation target. The inflation target of 2% creates a communication issue for policy. Ideally the target should not be inflation but having committed to it, the Bank has no choice but to communicate policy through it.

Vote and Comment by Andrew Lilico

(Europe Economics and IEA)
Vote: HOLD
Bias: To wait to raise rates until inflation rises.

Rates should have been raised in the past in line with the rule

Andrew Lilico said that after a long period of voting for a rise in rates by ½% he had altered his position to a rise of ¼% at the last physical meeting and in the January e-poll he voted to HOLD. He said that it would be a mistake to use the below target outcome to 'see through' the inflation figures. He was in favour of building credibility based on rule-following behaviour. Rates should have been raised in the past according to the rule. It is not appropriate to ignore the rule when inflation is below target. If a eurozone crisis re-emerges, then the Bank can revisit QE. Rates should rise only when inflation picks up.

Vote and Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: HOLD Bank Rate.
Bias: To rise in stages and QE to be used in the event of euro crisis.

Macroeconomic factors tip the argument in favour of a hold in rates

Kent Matthews said that his decision to be a modest Hawk at past meetings of the SMPC was based on balancing microeconomic arguments against macroeconomic ones. He said that the economy has reached the point where the stopped clock of holding rates is giving the right time. The microeconomic arguments pointed to a rise in the base rate while the macroeconomic arguments pointed to a hold. The misallocation of loanable funds and the ensuing financial repression caused by low interest rates remains a strong argument for a rate rise. However, the prospect of a Grexit and another euro crisis has added to the macroeconomic factors, swinging the balance against raising rates at the moment. The world will know what the prospects for a euro flare-up is very soon and there would be no purpose in raising the base rate only to lower it again in a few months. He voted to HOLD base rate but with a bias to rise as soon as the markets are less turbulent and to have QE in reserve to deploy if the euro crisis creates too much mayhem in financial markets.

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate; ½%;
Bias: To raise and QE to be reversed.

Vote and Comment by David B Smith

(Beacon Economic Forecasting)
Vote: Raise Bank Rate ¼%. No QE.
Bias: To raise Bank Rate.

Heading for a fiscal crisis….

David B Smith said that he wanted to make three points. First, the election creates considerable uncertainty. Whatever the outcome of the election, interest rates will probably have to rise. This was because there would probably be a relief rebound in private investment and recruitment if the Conservatives won, while a Labour victory could induce a potentially highly inflationary drop in the pound. Such a development could lead to major tensions between a government pledged to more fiscal spending and the inflation mandate of the Bank of England. Second, the national accounts data is so poor that a forward-looking interest rate policy is nearly impossible. Third, some economists now believed that the policy regime can be more robust under rules – including rigid rules such as the old gold standard - rather than the current discretionary approach. Fundamentally the economy could not escape the need for further fiscal retrenchment in the long term, Unfortunately, QE had created moral hazard for the government because it had removed the pressure to cut the budget deficit.. David B Smith said that at previous meetings and e-polls of the SMPC he had voted for a moderate ¼% rise. He felt that there had been no purpose in being too aggressive as he was mindful of the reaction of the bond and FX markets. Rather than 'flip flop', he said that he would stay with a ¼% rise and hold QE with a bias to further rises

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ¼%. QE restructure by £50 billion.
Bias: To raise rates to 1½% over 12 months.

Nominal GDP growth of 4-5% justifies a rise in interest rates

Peter Warburton said that he had been a consistent rate rise voter for some time and that he will continue in this way. The oil cartel is well and truly broken and will not be easily resurrected. Similarly the oligopoly structure of the supermarkets has also broken down with the implication for retail price inflation. Nominal GDP growth in the order of 4-5% justifies normality for interest rates. He said that it is important to send the message that rates need to return to 1½-2%. He also said that the Bank should be looking to sell its holdings of longer dated Gilts and offsetting this with purchases of infrastructure bonds and securitised loans. He suggested a transaction in the order of £50 billion. He voted to raise rates by ¼%.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)
Vote: Hold base rate. Hold QE.
Bias: Neutral

Economy continues with deleverage

Trevor Williams said that deleveraging in the economy was continuing and that the growth in broad money supply is not consisted with above trend growth. Growth in domestic demand is unsustainable because productivity growth remains flat. External uncertainties such as the slowing down of China and deflationary forces in Europe suggest that this is not the time to change monetary policy. He voted to HOLD the base rate with no bias.

Vote in absentia by Roger Bootle

(Capital Economics)
Vote: Hold base rate. Hold QE.
Bias: Neutral

Policy response

1. On a vote of five to four the committee agreed to hold Bank Rate. Four members voted for rise.

2. All four rate risers expressed a bias to raise rates further. One of the rate holders voted to raise rates when the euro situation is cleared.

3. There was a mixed recommendation regarding QE. Two members recommended that QE be reversed. Three members recommended that no further QE be deployed. One member said that QE should be held in reserve if the euro crisis worsens and another member recommended a restructuring of QE from Gilts to other types of bonds.

4. The narrow vote to hold rates reverses a long trend of a calling for a modest rate rise.

Date of next poll

21 April 2015

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 and IEA). Other members of the Committee include: Roger Bootle (Deloitte and Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffer), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Ruth Lea (Arbuthnot Banking Group), Patrick Minford (Cardiff Business School, Cardiff University), Gordon Pepper (Cass Business School), David B Smith (Beacon Economic Forecasting), 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 Corporate Markets). 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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