
IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes seven / two to hold Bank Rate in May.

Ahead of the General Election on 7th May, which has delayed the release of MPCs decision until 11th May, the Shadow MPC has once again voted seven / two to keep rates on hold.

At the second physical meeting of the year, the SMPC discussed the efficacy of the inflation targeting regime alongside its usual deliberations about economic and monetary issues and the stance of monetary policy. That debate, and a vote about options for change, is released in the body of the document. Regarding the decision to hold rates, those voting in favour had a range of reasons for doing so. One worried about whether the elections will produce a government immediately, so resulting in uncertainty damaging to the recovery. Another argued that the recovery was showing no signs of overheating, and that wage and price inflation remained low enough to justify leaving rates on hold. Yet another argued that he could not vote for a rate rise when the actual or measured inflation rate was zero, despite a concern that in the past the Bank had failed to raise rates when inflation was more than 1% above the target.

The dissenters were concerned about financial market distortions caused by leaving rates too low for too long, and wanted a return to normality as soon as possible.

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 polls will be released on the Sundays of 31st May and 5th July 2015, respectively.

Vote Minutes of the meeting of 21 April 2015

Attendance: Philip Booth, Roger Bootle, Jamie Danhauser, John Greenwood, Andrew Lilico (Chairman), Kent Matthews (Secretary), David B Smith, Peter Warburton, Trevor Williams (Co-Chairman), Roger Bootle (Capital Economics), John Greenwood (Invesco).

Apologies: Akos Valentinyi, Grahame Leach, Tim Congdon

Chairman's comments:

The existing Chairman Andrew Lilico said that with the 12-month anniversary of his chairmanship it is time to handover to Trevor Williams. Trevor Williams thanked Andrew for his stewardship of the Committee and explained the structure of the meeting.

The first half of the meeting is to be devoted to discussing the Briefing Note by Andrew Lilico on Monetary *Policy Anchors*. The second half will be devoted to Peter Warburton's preparation of the Monetary Situation, which will be discussed with Peter putting the case for a rate rise followed by a nominated person to put the case against.

He then invited Andrew Lilico to present his briefing note and to gather views of the Committee as to what if anything should replace the current objective of monetary policy.

Monetary Policy Anchors

Andrew Lilico said that as with the general election of 1997 when the UK's monetary policy framework was redefined an inflation target and operational independence of the Bank of England, it is plausible that the next general election will see a redefinition of the monetary policy framework. He said a second reason the monetary framework might change is that there is a widespread view that the inflation target has lost all credibility. He invited the SMPC to engage in a wide-ranging discussion by the SMPC on what kind of monetary policy framework should replace the existing one (if indeed it should be changed).

There was little support on the Committee to keep things as they are and a general discussion followed covering a range of issues from keeping the inflation target but changing the detail such as redefining the price index, changing the target, allowing for a zone of discretion, restoring credibility, introducing an asset price target, monetary targets, nominal GDP targets or simply returning to discretion.

A full discussion was had by the members. It was agreed that members of the committee would vote first on a framework and then second on the measurement of inflation. Andrew Lilico said that he would consult all members not present. (This consultation was held subsequently but no additional votes were offered.)

On an indicative vote four members felt that the inflation target should be supplemented with an asset price pillar. Three voted for a price level target and there were two abstentions. Kent Matthews said that he would like to have voted for a price path target and an asset price target but that combination was not on offer.

Trevor Williams asked Peter Warburton to put the case for a rate rise and invited Roger Bootle to put the case against before proceeding to the vote.

Economic Situation

The link between broad money growth and the growth of the economy has altered

Peter Warburton referred to his distributed paper on the Monetary Situation and introduced the contents starting with the international situation followed by the domestic situation. He said that he proposed a rise in the base rate although he recognised the superficial attractiveness of the status quo. There has been some recovery in M4 growth but this has begun to fade on the latest data. While prevailing broad money growth rates are well below the levels that would historically have been necessary to sustain adequate growth of nominal GDP, this relationship has clearly altered over the past 30 years.

Rates that were meant to be an emergency measure have been left too low for too long

He said that there were two points he wanted to make. First, it was a bad idea to leave rates at emergency settings for so long. Using a wide spectrum of indicators, there was every justification for the MPC to raise rates in early 2013. The failure to normalise interest rates when the opportunity was on offer, means that, should there be a downturn in the global economy, the remedy of lowering rates is unavailable.

Second, it was clear that leaving monetary policy too loose for too long had resulted in a misallocation of resources. An example is where large corporations have raised capital that they did not need and used the proceeds to redeem their stock in order to flatter their share prices. Another example is the diversion of private savings into government bond markets whose prices are distorted by central bank purchases. Another is the phenomenon of liquidity hoarding by banks and large corporations who have no incentive to lend out surplus liquidity because market rates are so low.

Sterling appreciation could damage the economy

Putting the case against raising rates Roger Bootle said that he was not aware of any distortions caused by zero interest rates. He said that any distortions fall under what Auditors might call *de minimis* representing minor second-order effects. He asked where the distortions of any size were. Lending

**Distortions caused by
low interest rates are
second-order...**

goes on in the money market. He said that he was more concerned with the value of sterling. The pound is much too high for a sustained recovery. If an early rise in the base rate occurred sterling will appreciate and damage the economy. He said that inflation was still zero and so we still have time. Peter Warburton asked if he counted the distortions in the Gilts market. Roger Bootle said that he would also add the distortions caused by regulatory policy but that these are not the result of low interest rates. John Greenwood said that low credit growth points to distortion in the credit market. Trevor Williams said that there has been a pick-up in unsecured credit growth but accepted that compared with business lending this was small.

Trevor Williams said that bond prices and house prices are high and this could be viewed as a distortion. John Greenwood said that there were two ways asset markets are affected by monetary policy. High credit growth could drive rising asset prices, or asset prices could rise because interest rates have fallen. What the economy is experiencing is the latter not the former.

Discussion

Trevor Williams called the meeting to order and invited Philip Booth to be the first to give his recommendation with his reasons

Comment by Phillip Booth

(Cass Business School and IEA)

Vote: Raise Bank Rate by ½%

Bias: None

Phillip Booth said that there was a huge amount of uncertainty about the economic situation and how it might change. Growth was still low, but this is probably not due to the monetary policy stance. In such a fog of ignorance he said was torn between the status quo and a return to normality - both of which are rational responses. The risks of doing nothing were to continue to fuel a bond market bubble as well as to encourage levels of business and household borrowing that were not sustainable in the long term. On balance, he believed that we should return to normality. He had no bias as he believed that whatever needed to be done should be done quickly.

Comment by Roger Bootle

(Capital Economics Ltd)

Vote: Hold Bank Rate

Bias: No change

Roger Bootle said if a new government embarked on a fiscal expansion and the pound falls sharply, then we can expect a rate rise. But in its absence, he voted to hold with no bias.

Comment by Jamie Dannhauser

(Ruffer)

Vote: Hold Bank Rate

Bias: To hold

One year ahead: Rate to rise

UK is a small open economy....vulnerable to act independently

Jamie Dannhauser said that low inflation was the result of positive supply shocks. The UK is a small open economy and that for the Bank to raise rates independently of the Fed, Japan and the ECB is dangerous. The possibility of a Greek exit or a managed default and a crisis in the euro remains an ever present threat. He said that he expected the Bank to withdraw some stimulus opening up the likelihood of a rise in the next 12 months.

Comment by John Greenwood

(Invesco Asset Management)

Vote: Hold Bank Rate

Bias: Neutral

Economy is recovering.....but weakness is in money and credit growth

John Greenwood said that stock prices are inflated and house prices particularly in the London area are inflated. He said that he recognised that there are international pressures working in the London housing market but importantly it is not being driven by credit growth. His view is that asset prices are reflecting a low interest rate environment. The real economy is recovering but wages remain weak and there is no sign of overheating. Employment is recovering, but wage growth is still weak. The weakness is also evident in the growth of money and credit but he said that part of the low inflation is a result of external pressures from commodity prices. He voted to hold rates with no bias.

Comment by Andrew Lilico

(Europe Economics)

Vote: Hold Bank Rate

Bias: To raise rates as inflation rises above target

Mistake not to have raised rates earlier...

Andrew Lilico said that it was a mistake not to have raised the base rate in the past but the Bank's strategy now needs to be played out till the end. He said that perhaps the output gap is wider than he thought. He said that he could not argue for a rate rise while inflation is zero and that rates should only rise when inflation is forecasted to rise above target. In deficits are concerned.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Hold Bank Rate

Bias: To raise Bank rate as inflation returns to target

Arguing for a rise in Bank rate when inflation is zero will damage the credibility of the SMPC

Kent Matthews said that his arguments for raising Bank rate in the past have been largely microeconomic rather than macroeconomic. He recognised that there may be short term pain in a rise; he had argued that interest rate rises should be small and in small steps. However, the problem with arguing for raising Bank rate when inflation is zero is that the SMPC will lose credibility and the sophistications of microeconomic versus macroeconomic factors be swept aside. He voted to hold bank rate but to raise rates in small steps on the earliest opportunity.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Hold Bank Rate

Bias: To raise Bank Rate in two steps

UK in unprecedented political situation...

David Smith said that the Base rate will not be raised immediately in the post-election period. The results of the election may produce no government and politics after May could be radically different. There are also uncertainties about the path of public expenditure pending the return of some form of coalition government. He voted to hold Base rate for now but to raise rates in two stages.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by ¼%

Bias: To raise rates to 1½% over 12 months

**Negative psychological
impact of rate rise, but....**

Peter Warburton said that the potential for a negative psychological impact of a rate rise is greater in the current economic climate. But he has been constant in arguing for a rate rise and in the past has advocated a 50bp rise. He is now arguing for a nominal rise of 25bp. He said that rates should rise in stages to a target of 1.5% over the next year.

Comment by Trevor Williams

(Lloyds TSB Corporate Markets)

Vote: Hold

Bias: Neutral

**Economy slowing with
a large current account
deficit....**

Trevor Williams said that the economy has a large current account deficit, which has negative implications for sterling, and the pace of growth is showing signs of slowing down. With wage inflation still moderate and consumer price inflation likely to turn negative before rising, now is not the time to raise interest rates. There is a global deflationary bias which makes a rise in UK Bank rate inappropriate at this time. He voted to hold Bank rate with no bias for a further raise.

Policy response

1. On a vote of seven to two the committee agreed to hold the Base rate at its current level.
2. One member voted to raise Bank rate by 50bp and another voted to raise it by 25bp.
3. Of the seven that voted for a hold, four expressed a bias to raise rates over the next 12 months.

Date of next meeting

Tuesday, 14th July 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 Trevor Williams (Lloyds Bank Commercial Banking and Derby University). 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), Andrew Lilico (Europe Economics and IEA), 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) and Mike Wickens (University of York and Cardiff Business School). 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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