IEA Shadow Monetary Policy Committee

July 2015

Institute of Economic Affairs

For further information please contact:

Trevor Williams	+44 (0) 20 7158 1748	trevor.williams@lloydsbanking.com
Philip Booth	+44 (0) 20 7799 8912	pbooth@iea.org.uk
Richard Wellings	+44 (0) 20 7799 8919	rwellings@iea.org.uk

Embargo: Not for publication before 00:01am Sunday 5th July.

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

Once again, the SMPC vote is split in favour of leaving rates on hold. But the vote has narrowed to 5 to 4, the same as in February. The next domestic policy milestone is the Budget on 8th July.

The majority continued to argue that rates should remain on hold due to global events, including a Greek default, and weak domestic inflation.

Those arguing for higher rates are concerned that two years into a robust recovery and with wage inflation rising strongly by recent standards, spare capacity diminishing, distortions building in asset prices, there is still no signs of a rate rise from the UK central bank. They argue that rate rises should be enacted as soon as possible. Two of those that voted to keep rates on hold commented that they should be higher and want a rise soon.

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. The next two SMPC polls will be released on the Sundays of 2nd August and 6th September 2015, respectively.

Votes

Vote by Philip Booth

(Cass Business School and IEA)
Vote: Raise Bank Rate by ½%.
Bias: None.

As the economy normalises and it becomes increasingly clear that growth problems are to do with low productivity, it is time for monetary policy to normalise. If markets see that interest rates are going to be held low regardless of the circumstances, there is a chance of creating an asset and credit bubble.

Vote by Jamie Dannhauser

(Ruffer)
Vote: Hold Bank Rate & QE.
Bias: No bias.
One year ahead: Bank Rate at 1%; no change in QE.

Depressed underlying inflation provides a reason to hold rates

Same vote and commentary from the June meeting.

Vote by John Greenwood

(Invesco Asset Management)
Vote: Hold Bank Rate.
Bias: Neutral.

Slow growth of credit and low inflation suggest that rates can stay on hold

Same vote and commentary from the June meeting.

Vote 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 but a hold now

No change to vote or commentary from last month.

Vote by Patrick Minford

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

Election outcome has given economy a boost

The removal of electoral uncertainty has given the UK economy a substantial boost. There is now the prospect of five years of a centre-right reforming government, with the reduction of public spending at its heart. This reduction alone will raise public sector productivity and lead to necessary reform; the public sector is largely incapable of improving performance until resources are reduced. This has always been the Treasury's mantra and it seems to have been demonstrated by the reaction to the cuts so far. For example, the police have improved front-line services in spite of large cuts; it seems to have prompted the use of auxiliaries, which are a good innovation. The Department of Defence has been a byword for waste for decades; it may be that now it finally has to sink inter-service rivalries to survive.

Much concern has been expressed about the EU referendum but it all depends on how the EU reacts to UK demands for reform

Commentators are now wheeling out the EU referendum as the next concern. However, this will turn crucially on how the EU reacts to UK demands for reform. If it rejects them outright, as seems most likely, then the majority of UK businesses will turn against the EU and will welcome an Out vote; with business in favour popular opinion will produce an Out result. If the EU accepted them, then the case to leave would be much weakened; it would be difficult to argue against the case for giving the new reformed set-up a chance to work.

The other uncertainty about which there is much muttering is the lack of productivity growth in recent years. Yet until recently with wages growing so weakly and falling in real terms there has been little pressure to reduce labour use. This will change steadily as the economy's resources get tight. Already real wages have started to rise strongly and the Bank is beginning to notice.

Productivity will rise as real wages rise – firms will react by seeking better returns

The outlook for the UK economy shines by comparison with that of eurozone economies. Yet even there it may well be that the austerity policies pursued on the continent begin to pay dividends as demand recovers.

World growth is running in the 3-4% range which is below the heady rates of the 2000s but looks as if it will sustain weak raw material prices for a decade at least. This should allow a long upswing to take a grip on the world economy.

Overall, it is hard not to be optimistic about the business cycle outlook over the next decade. Looking back, we increasingly can see that the 'trend' of world output before the crisis was simply unsustainable. The spiralling prices of raw materials should already have told us that. Also the rising bad debts in certain sectors, led by real estate, should have told us the same. The post-crisis economy is discovering which sectors can flourish in the new slower-growing world.

Non-bank credit will fast enough soon to a boom that might become a threat to stability. Start to normalise rates now

Can one make any sense of the argument that the world is entering a 'flatlining' period of stagnation? Will real interest rates remain low or even negative? Will nominal interest rates remain stuck at the zero bound? I do not think so. The US is likely to raise interest rates later this year. The UK can hardly fail to follow soon after. Credit growth is weak because of bank regulation; but non-bank credit will surely expand fast and bypass the regulators – indeed it may well already be doing so – but the 'shadow' statistics of these internet markets are hard to get hold of, precipitating the need to stop the creation of money by governments.

I think it will therefore not be too long before monetary policy returns to a more recognisable form and that the next boom in credit materialises as the new threat to stability. My vote as usual is for that process to start now and I maintain last time's advice.

Comment by David B Smith

(Beacon Economic Forecasting)
Vote: Hold Bank Rate.
Bias: Prepare markets for two ¼% hikes in Bank Rate, starting in August.

Forthcoming Budget constrains MPC actions

With the post-election Budget due on 8th July, any rate announcement the following day other than a continued hold in Bank Rate might be considered politically controversial. So, no change in either Bank Rate or the stock of Quantitative Easing is almost certainly the way to bet. Having delivered a Coalition Budget as recently as 18th March, it is not obvious why a second set of Budget measures is now required from a fiscal viewpoint, unless Mr Osborne wants to set out a markedly different course from that agreed to in coalition. Presumably, Mr Osborne wants to lay down political markers for the five-year life of the next Parliament, adopt a more parsimonious approach to welfare spending than would have been possible previously, and introduce supply-side orientated reductions and simplifications in the burden of taxation. Despite the widespread view to the contrary, reductions in marginal tax rates that are offset by government spending reductions, leaving the Budget stance unaltered, should lead to unchanged or even lower interest rates. This is because lower taxes augment the supply side, strengthen sterling and widen the output gap, other things being equal. Furthermore, at least some one half to two-thirds of any ex ante cut in tax rates seems to eventually comes back as increased revenues or reduced government outlays on welfare, once allowance is made for the second-round and subsequent effects involved. Such dynamic considerations – which are simply not present in the forecasting models maintained by the Bank of England and the Office for Budget Responsibility – also explain why it is almost impossible for a government to tax its way out of a large structural budget deficit. If the required ex ante hike in taxes is some two or three times the intended ex post reduction in government borrowing, the arithmetic rapidly becomes unsustainable once this is taken into account. It is unfortunate that the Conservatives did not make this point during the election campaign.

Possible pent up home demand, and upwards revisions to UK growth data

If the Chancellor is planning to move in the direction of 'Reaganomics' on 8th July, this would almost certainly be good for the long-term health of the economy and probably lead to a better medium-term fiscal performance than most commentators are currently expecting. One major uncertainty, however, is how much private sector activity was postponed before the election – because of the perceived political risks at the time – and how far this will be followed by a relief rally in private investment, recruitment and household consumption. The anecdotal evidence suggests that this may be starting to happen, albeit too recently to be picked up in the published official statistics. The Office for National Statistics (ONS) national accounts data, released on 30th June, introduced some important upwards revisions to the economic growth rate in 2014, which is now estimated to have been 3% rather than the 2.8% published immediately previously (the very first estimate was 2.6%), and in 2015 Q1, when the annual growth rate was revised up by 0.5 percentage points to 2.9%. With the volume of household consumption having increased by 3.4% in the year to 2015 Q1 and real business investment up by 5.7% over the same period, the economic conjuncture is beginning to look more like 'boom-boom Britain' than the slough of despond that left-wing commentators still appear to believe in.

Current account deficit suggests an excess of home demand over aggregate UK supply

An additional reason for concern about the supply-demand balance facing Britain is the continued leakage of excess home demand into the trade deficit and the balance of payments. The revised statistics published on 30th June show that the current account deficit widened from 4.5% of market-price GDP in 2013 to 5.9% last year and was still 5.8% in the first quarter of 2015. This was largely because of the poor performance on the UK's net overseas investment income, which may not be measured accurately however. A more favourable position was shown by the deficit on net trade in goods and services, which was unchanged at 2% of GDP last year and eased to 1.6% in the first quarter of this year. With Britain's net overseas investment approaching minus £290bn in the first quarter, however, the economy must remain vulnerable to any loss of overseas confidence in the way it is being managed. The need to maintain his fiscal credibility in the international financial markets is likely to be an important factor in Mr Osborne's decision making.

Broad money growth is adequate to sustain recovery and labour market is strong

With the M4ex broad money definition having grown by an unchanged 4.4% in the year to May, which is broadly the fastest that it has been since the autumn of 2013, there seems to be little reason to worry that the growth in the supply of broad money is inadequate to fund a continued expansion of home demand. The domestic labour market also remains strong, with both the Labour Force Survey and Claimant Count measures of unemployment falling further in the most recent figures and employment continuing to rise. Private sector earnings were up by 3.3% in the year to February-April. However, the whole economy figure was more subdued at 2.7% because public sector earnings only increased by 0.3% over the same period. With CPI inflation running at a mere 0.1% in the year to May, and the tax and price index up by 0.5% over the same period, economy wide real earnings per head are now unambiguously rising. At the same time, the labour force is continuing to grow, providing a positive 'double whammy' where the ability to fund household consumption is concerned.

Bank rate recommendation

One reason for holding Bank Rate on 9th July is that the forthcoming Budget measures might encourage capital inflows into the UK and push up sterling even further. There is also the on-going Greek drama playing out in the background, which might create enough turbulence to ensure that a rate hold becomes justifiable on international rather than domestic grounds. However, the Bank of England should be making a start on preparing the ground for a couple of modest ¼% rate hikes, possibly as early as the 6th August decision when a new set of Inflation Report forecasts will be available. If British rate setters wait for the US Federal Reserve to make the first upwards move, which may be the current philosophy, they could easily end up doing too little too late, especially as quarter-on-quarter growth in the UK in 2015 Q1 appeared markedly stronger than in the US, after recent data revisions.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%.
Bias: To raise Bank Rate in stages to 1.5%.

Economy is rebounding and should be a reminder to the MPC of the need to raise rates

A rebounding economy and an acceleration of average earnings provide timely reminders to the Monetary Policy Committee that they stand apart from the reaction functions of all pre-2008 MPC's before them. All these previous MPCs would have responded to the tightening signals from product, labour and housing markets and begun to increase Bank Rate many months, if not years, ago. The MPC has grown so used to sitting on its hands every month that there is a real danger that the circulation to its button-finger has been cut off. The latest batch of labour market statistics contains ample reassurance that inflationary pressures are building steadily. Whereas a year ago, market strength was represented primarily in headcount growth, today it is showing as private sector average earnings inflation. Pay growth in construction and in wholesaling, retailing, hotels and restaurants has surged in the past three months. Financial markets view with increasing incredulity the insouciance of the Bank of England's policy committee.

Judging by the May Inflation Report, The Bank of England is unimpressed: rather than accept that the UK has moved into an overtly inflationary mode, the Bank clings to its view that "the degree of slack is broadly in the region of 0.5% of GDP" – thereby justifying the 'no action' pose they have adopted for more than six years in the case of Bank Rate and three years for QE. Any thoughts that the Bank was merely waiting for the election to pass before raising Bank Rate can be dismissed – based on the interest rate futures curve, the first Bank Rate increase is timed for Q2 next year.

The other piece of data the Bank might have weighed is the announcement that there will be a new Budget on 8th July

The other piece of data the Bank might have weighed is the announcement that there will be a new Budget on 8th July, to include all the nasty details that were omitted from the March Budget for fear of frightening the horses. As the day draws closer, the grim reality of the UK's fiscal predicament will come into sharper focus. Chancellor Osborne's 'Stability Budget' will revive memories of the urgency and earnestness of the first coalition budget in the summer of 2010. Instead of pointing to the crisis that lay behind, Osborne's task is now to point to the crisis that lies ahead, should the UK government fail to address the deep structural imbalances in the public finances.

This is a much harder proposition to sell to the electorate. First, the economy has been performing much better in the past 2 years and the perception of economic danger has lessened. Second, the government's cost of borrowing remains incredibly low, such that 4% Consols were redeemed recently in order to be replaced with less expensive stock. Third, international appetites for voluntary fiscal tightening have given way to popular revolts against 'austerity' measures. Fourth, the greater dependence of Scotland, Wales and the northern regions on public expenditure and welfare implies that they will bear the brunt of further spending discipline, amplifying regional political tensions.

The UK's credit rating is at risk from high debt – the highest of all nations rated AAA at 83% of GDP

Standard and Poors, the rating agency, recently placed UK sovereign debt on "negative outlook", citing the public debt to GDP ratio of 83% - the highest of all the nations rated AAA, current account vulnerability, uncertainty associated with the outcome of the EU referendum poll and "unrealistic deficit reduction targets". Hence the Chancellor must confront two distinct challenges in the months ahead: from those who believe that further fiscal consolidation is either unnecessary or inadvisable, and therefore should not be done and from those, like S&P, who dispute that it can be done.

A glance at the data confirms the immensity of the task of restraining current public spending. The largest line item, relating to social security payments, is like a super-tanker that takes 10 miles to slow down. Debt interest payments, despite ultra-low interest rates, are rising inexorably. Work and pension payments and net public service pensions are increasing due to demographic factors. Staff costs are subject to a pay freeze, but even this will be difficult to enforce given the pressures of delivering public services to a satisfactory standard. The restraint of current spending requires that the remaining ingredients of the budget – departmental spending – are pared back significantly.

Debt service is 3% of GDP; each 1% of GDP adds £18bn to the interest bill

At 3% of GDP, public debt service costs are still well below their historical average despite the elevation of the public debt ratio. Each 1% of GDP added to the interest bill represents £18bn in today's money. The long average duration of UK gilts – about 14 years – offers good protection against the upward march of interest rates, but there is no room for complacency on this score.

An examination of the evolution of the public finances during the past 6 years, with the focus on the line item "public sector net borrowing excluding the Asset Purchase Facility and the Royal Mail Pension Plan" is revealing. Two years of heavy lifting were followed by two years of minimal progress (2012-13 and 2013-14). The good news is that the deficit closed more rapidly in 2014-15 than was originally thought, due to underspends on general government procurement. As a result, the government entered 2015-16 with a following wind and further progress is expected. The task of sustaining this pace of improvement is set to become progressively more difficult as the parliament unfolds. By 2017, the fiscal imperative will loom large in any evaluation of the prospects of the UK economy.

If the government has regained the confidence to close the fiscal gap, the Bank should be confident to commence its own normalisation. Despite its extremely upbeat assessment of the labour market, the Bank has the habit of upgrading the supply potential of the economy so as to leave the margin of supposed slack constant. A chart (4.6) in the Inflation Report reveals the unusually large depressing effect on wage inflation of compositional effects over the past year. On the reasonable assumption that this will settle back towards zero in the context of a tightening labour market, it would imply that up to 1 percentage point of wage inflation should be added to the 3.3%, which is the latest 3-month average for private sector earnings growth. Survey indicators suggest that further wage acceleration is probable, regardless of compositional effects. Don't bank on a surge in labour productivity to save the day. One day soon, this roaring labour market will shake up the complacent consensus regarding the timing of that first Bank Rate hike.

Bank should raise rates by ¼% at its July meeting to start the process of normalisation

As the UK economy regains momentum after its pre-election lull and as house prices surge forward again, now is the time to bite the bullet and raise Bank Rate, initially by 0.25%, at the July meeting.

Vote by Mike Wickens

(University of York and Cardiff Business School)
Vote: Raise Bank Rate by ¼% and decrease QE to £250bn.
Bias: To unwind QE and slowly raise rates as the economy grows.

Based on fundamentals, bank rate and interest rates should be higher

Same vote and rationale as at the June meeting.

Vote by Trevor Williams

(Lloyds Bank & Derby University)
Vote: Hold.
Bias: Neutral.

Greece adds a further degree of international risk

The big external news is, of course, the Greek failure to pay the IMF loan repayment due at the end of June, which raises the external risk to the UK economy, But, arguably, that risk has been priced into markets for some time, though it entails a continuing high level of market volatility. Domestically, the ONS has revised up UK growth for last year to 3% and growth in Q1 2015 to 0.4% from 0.3%. This was pretty much as expected.

However, the UK statistical office also revised the external deficit to 5.9% of GDP, the highest since records began in 1948. No doubting that this is a consumption-led economic recovery but, thankfully, one driven by gains in employment and falling unemployment rather than excessive increases in household debt. Productivity remains the Achilles' heel of the recovery, however, and the need is for the internal deficit from the public sector to come down to offset the rise in the external deficit. This will possibly entail a tighter fiscal stance at the 8th July Budget and so, as an offset, in the short-term at any rate, a looser than otherwise monetary policy stance seems likely.

With price inflation still low, just 0.1% up in the year to May, I would leave rates on hold for now

The news from money supply and credit suggest a slowdown is underway in the domestic economy. Annual growth in M4 lending on the preferred measure of the authorities, M4ex, is down on average in the 2 months of Q2 so far, from 5.5% in Q1 to 4.3% Q2. Household borrowing is -0.3% year over year, showing that consumer growth is not debt driven. Hence, the good news for the economy is that, though the recovery has been led by consumers, it has not been down to increasing debt but growth in employment and falling prices of retail goods. On that score, though unemployment is falling, it is falling at a slower rate. With price inflation still low, just 0.1% up in the year to May, I would leave rates on hold for now.

Policy response

1. On a vote of five to four the committee agreed to hold the Bank Rate at its current level.

2. Two members voted for a rise of ¼%, one for ½% and one for a rise of any description.

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 (Eureope 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.

Institute of
Economic Affairs

Institute of Economic Affairs
2 Lord North Street
London
SW1P 3LB

www.iea.org.uk