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 August.

By a majority of one, and for the second successive month, the Institute of Economic Affairs (IEA) Shadow Monetary Policy Committee (SMPC) voted to keep Bank Rate at 0.5% in August. However, the narrowness of the vote is misleading about the underlying momentum on the committee. Seven of the nine SMPC members had a bias to raise rates, an increase of three on the last meeting.

The minutes of the next official Monetary Policy Committee (MPC) meeting will be released on the same day as the decision - shortening the period by 2 weeks. The Quarterly Bank of England *Inflation Report* will also be published on the 6th August, and it will in future coincide with the MPC decision and minutes every third month. The Bank of England's August press conference will therefore cover the *Inflation Report*, the MPC decision and the minutes. That should make it interesting and also more transparent by linking policy to changes in underlying assumptions and setting the parameters of the MPC's debate.

The majority on the SMPC think it is too early to raise rates, as the global economic backdrop - not just in Continental Europe but also China - remains worrying at a time when price inflation is exceptionally low.

Arguments for a rate rise are focussed on the strength and longevity of economic recovery in the UK, which is using up available spare capacity, the rising pace of wage inflation, the recovery in the housing market and in money and credit growth, as well as the fact that the supply side, in their view, is being damaged by keeping rates too low for too long.

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 6th September and 4th October 2015, respectively.

Minutes of the meeting of 14th July, 2015

Attendance: Roger Bootle, Jamie Dannhauser, John Greenwood, Graeme Leach, David B Smith, Peter Warburton and Trevor Williams.

Apologies: Phillip Booth, Tim Congdon, Anthony J Evans, Andrew Lilico, Kent Matthews, Patrick Minford, David H Smith, (Sunday Times observer), Akos Valentinyi and Mike Wickens.

Chairman's comments

The Chairman, Trevor Williams, thanked those attending and invited Jamie Dannhauser to present the monetary situation.

International Background

Jamie began by identifying a number of global prospects and risks which he discussed in turn. He began by mentioning the possibility of dislocation if the situation in Greece were to implode. There is a risk of contagion to the Eurozone generally and the UK in particular that might require a modification to monetary policy. In his view, the biggest risk however was not Greece but China, where a debt over-hang and abrupt stock market reversal was a potential trigger for a financial crisis that may well have global fallout. In China, the weakness of the economy between January and April has since been reversed by some more positive readings of recovery such that the second quarter GDP growth figure was above expectations at 7%. However, activity in emerging markets generally had surprised to the downside, reflecting in part the slowdown in China.

In the US, the response of consumer demand to the dramatic fall last year in the oil price has been less positive than expected. In particular, there was much greater weakness in the first quarter of the year than had been anticipated. Jamie suggested that the potential for a cyclical bounce in the US economy was rather greater than some others had suggested, and he drew attention to a New York Federal Reserve Bank survey showing that credit-constrained US households were more confident about finding a new job, should they lose one today, and more willing and able to access credit, than in the previous year.

Jamie spoke briefly about Japan, noting that the economy had recovered in 2015 on the back of a weaker Yen. He posed the question whether there had been a net boost to global demand from Japan's recovery or whether this had merely been a transfer of demand from other countries to Japan. Moving on to the Euro area outlook, he noted that the recent European Central Bank (ECB) lending survey had continued to reveal improvement in credit conditions; in particular, lower borrowing costs in Southern Europe. The underlying pace of growth in the Euro area may now be about 1.5%. He linked these remarks to the expectation that U.K exports to Europe might have some potential to recover based on the rise in composite Euro area purchasing manager indices.

Trevor Williams asked whether Eurozone small- and medium-sized enterprises had increased their take up of credit. Jamie Dannhauser replied that he had no direct evidence of this but that a 6 monthly survey from the European Central Bank suggested that access to finance had become easier over the past 12 months.

UK background

Jamie then moved to discuss the U.K economic outlook. The U.K has enjoyed two years of robust and relatively balanced output growth. Jamie noted that the strength of the upswing in 2013 was not widely anticipated. Since then the growth rate of the market sector (that is excluding the public sector and the offshore oil industry) have been stronger still. During a period of fiscal consolidation and weakening oil production, the market sector had enjoyed growth rates of close to 4% per annum. Notably in the first quarter of 2015 when quarterly GDP growth dipped to 0.4%, private domestic final spending held up well. This has been a relatively balanced recovery with fixed investment featuring strongly and net exports becoming a less negative influence on GDP. Nor is this a debt-fuelled recovery. The growth of lending has remained very low and the stock of debt in relation to GDP for the U.K private non-financial sector has fallen over the past 6 years. The BIS (Bank for International Settlements) definition of the credit gap is negative in the case of the U.K.

Turning to the labour market, the U.K unemployment rate is now close to the Bank of England’s estimate of the median term natural unemployment rate and it is increasingly hard to maintain the notion of labour market slack. The proportion of young adults not in employment, education or training has fallen abruptly and this may have implications for the demand for housing units as more young adults desire to form households.

It is notable that there has been a sustained downward move in the headline inflation rate as well as domestically generated inflation and various measures of core inflation. Sterling strength may be biting in terms of its influence on input prices and a restraining influence on core inflation. The banking sector has also been deleveraging in recent years and Jamie posed the question of how safe do we want banks to be? On a historical comparison of the ratio of assets to shareholders funds, it is notable that there has been a reduction in the leverage of the banking sector. Jamie also drew attention to elevated consumer confidence readings, supported by the petrol price drop and the fairly buoyant housing market, and an output surge in business and professional services. Until recently, there has been depressed wage growth despite the strength of employment growth, in a manner consistent with a sizeable positive supply shock. However in the recent months, wages have accelerated and employment growth has slowed.

Is this now the right time to begin the normalisation of interest rates? Jamie considered both the case against normalisation and the case for normalisation. On the case against, he noted the fact that core inflation and other similar measures remain stubbornly low and that there may be asymmetric effects on demand from even a small upward move in rates. He referred to the recent speech by Bank chief economist Andrew Haldane entitled ‘Stuck’ in which mention was made of the psychological damage that a rise in rates could have.

In addition, there were risks around the global growth path which seem to be skewed to the downside, particularly for China and emerging markets. A further argument against the normalisation of interest rates was the potentially large impact it could have upon Sterling. Finally, he mentioned the fact that the UK is at a relatively early stage of its credit cycle and it might seem premature to raise rates at this point.

Considering the case for normalisation of interest rates to begin, he reiterated that the UK had enjoyed two years of economic growth well above its potential output trend which was likely to have absorbed most remaining economic slack. Indeed, the economy has picked up momentum heading into the second half of 2015 suggesting that any vestiges of slack will be quickly burned away. Wage growth has ticked up, notably consistent with previous survey evidence, and medium term inflation expectations bottomed at around 2.6%.

Meanwhile, monetary growth has been solid once the contribution of intermediate other financial corporations is excluded (i.e., the M4ex definition). Jamie noted that there had been arguably a distortion to this measure from the large funds flow into pensioner bonds and that correcting for this would show monetary growth to be even stronger. UK credit conditions continued to ease, notably, effective mortgage rates fell further in the last year. The July Budget eased up on the pace of fiscal consolidation for the next two financial years, suggesting that there was more room to tighten monetary policy as the fiscal consolidation had slowed down. Finally, he mentioned that the equilibrium risk free rate appears to have moved higher as credit access has improved; this again would suggest that there was scope for interest rates to be raised.

Discussion

Trevor Williams thanked Jaime Dannhauser for his wide ranging and comprehensive presentation, and opened the meeting to general discussion. David B Smith commented that the July Budget had been demand-side positive but supply-side negative. He referred to the announcement of the effective raising of the minimum wage through the new National Living Wage, as likely to increase the natural rate of unemployment and to contribute more inflationary pressure in the medium term. This meant that the Bank would have to be more hawkish in the medium term to achieve the same inflation goal.

Graeme Leach mentioned the statement of the Prime Minister relating to the desire to equalise gender pay as another example of interference with the operation of labour market, again something, which is likely to lead to higher unemployment and more inflation. Trevor Williams observed that there could not be much spare capacity and that is why the current account deficit was so large. Roger Bootle commented that the source of the large current account shortfall was not due to an increase in the trade deficit, which had moderated as a percentage of GDP, but rather it was the expanding deficit on investment income.

Jamie Dannhauser said that import penetration has flattened off, post the economic crisis having been rising for the previous 15 years. Overall trade performance had improved since Sterling depreciated in 2008. David B Smith commented that estimated statistical relationships suggested that the Marshall-Lerner conditions have not been met for some time, meaning that the sum of absolute values of the UK’s import and export price elasticities was less than 1. He commented that the sensitivity of trade volumes to relative prices has become noticeably less over the years as aspects such as technical performance, variety and reliability had assumed greater importance. He continued with the observation that the public sector net borrowing requirement may not improve much in cash terms over the next few years but was still likely to fall as a share of GDP. Peter Warburton drew attention to the financing issue behind the UK current account, namely that it was to the UK’s advantage that the current account deficit was matched almost entirely by a public sector budget deficit, financed by the issue of fixed interest securities. These were currently attractive investments for overseas holders and therefore enabled the UK to finance its current account deficit relatively easily, but this may not continue to be the case.

Trevor Williams called the meeting to order and invited members to vote.

Vote by Roger Bootle

(Capital Economics)
Vote: Leave Bank Rate unchanged.
Bias: To raise Bank Rate.

Slack in the economy, gyrations in Chinese stock markets and a desire to move after the US on rates

Roger was closer to voting for a rate rise than at any time since the recession, but did not believe today was the right time to change his view. He believes that there is still a fair amount of slack in the economy. He would rather see the US Federal Reserve raise interest rates before the UK does. He is aware also of the potential for a dislocation to come from the gyrations of the Chinese equity market, and for these reasons would wish to defer the first rate rise until next year. Roger expressed surprise at the content of the July budget which he thought would have been more likely to have emerged from a Labour chancellor than a Conservative one, and he was concerned at the degree of interventionism that the chancellor had indicated.

Vote by Jamie Dannhauser

(Ruffer)
Vote: Leave Bank Rate unchanged.
Bias: To increase Bank Rate.

Worried about the impact of Greece and is not convinced the UK should move ahead of the US

Jamie Dannhauser said he was veering towards voting for a rate hike but the situation in Greece caused him to exercise caution at this point. After 2 years of rapid economic growth and deleveraging both in the real economy and the banking sector, it is clear that the margin of spare capacity is limited and the evidence on the increase in wage inflation is convincing. Furthermore, he was not fully persuaded that the neutral or terminal rate of interest had fallen as far as had been suggested by academic or central bank analysis. To the extent that the Greek situation could yet unravel in a destabilising way for the UK, he preferred to leave interest rates on hold but with a bias to raise in future months. Moreover, he did not agree with the idea, suggested by some, that the UK should not precede the US Federal Reserve in raising rates.

Vote by John Greenwood

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

There should be a focus on credit growth

John Greenwood thinks it is important to consider interest rates in the context of money and credit. In the case of the US, credit growth was falling between 2008 and 2011 and then it began to recover but only very weakly between 2011 and 2014, necessitating Quantitative Easing (QE) at this time. However, he reckons that too much focus has been placed on the interest rate effect, and that now that US credit growth is as high as 8% per annum, there is a strong case for handing over the baton to commercial banks, that they are able to create enough credit for economic recovery without needing as much help from policy. In his analysis, the key question is 'what would happen to credit growth if interest rates were raised'. If credit growth was maintained then clearly there would be no problem but his concern is that this would not be the case.

Growth in UK money supply and credit do not warrant a rate rise

He alluded to a number of examples of premature interest rate hikes, mentioning Japan in 2000, the Eurozone in the early stages of recovery, Sweden, more recently Israel, New Zealand and China. He takes these to be cautionary tales of the dangers of raising interest rates too soon. John reminded us that his position has been for unchanged interest rates for a long time and he did not see enough of a shift in the environment to justify a rate hike now. He noted that the customer funding gap, the difference between customer loans and customer deposits in M4, has shrunk from 50% of GDP at its maximum, to something like 1% today (a mere £21bn), so he acknowledged the healing in the financial system. His caution over raising rates at the present time revolves around the slow growth of UK broad money stock, around 4.5% per annum, and he believes that the prospective consumer price inflation is not yet particularly strong, with an expectation of CPI inflation well below 2% into 2016. So on this basis, his vote is to keep rates on hold with no bias.

Vote by Graeme Leach

(Legatum Institute)
Vote: Leave Bank Rate unchanged.
Bias: To raise rates.

Core inflation is low and wage inflation could slow

Graeme said that for the first time since the financial crisis he had a bias towards raising rates but that didn't mean he was convinced rates should be raised.

He said those advocating a rate rise point towards the acceleration in earnings growth above 3% in 2015 and a fall in the unemployment rate towards the NAIRU (non-accelerating inflationary rate of unemployment) at around 5% (LFS measure). They throw in record high consumer confidence, a perky housing market, stronger business investment intentions and increased risk appetite from the banks, and the case for a rate rise appeared to be increasing, or was it?

Normalisation of rates conditional

He pointed out that normalisation of interest rates had always been conditional on the economy attaining 'escape velocity' i.e. the point when the commercial banking system is in a position to finance recovery, as opposed to dependence on the central bank and quantitative easing. Improvements in bank leverage suggest that this point may (stress may) have been reached, but we can't be sure. He thinks the last thing the MPC would want to do is raise rates and then be forced into a humiliating reversal. Caution will surely be the watchword. Bank of England Chief Economist, Andrew Haldane's recent comments on 'asymmetry' suggests there are real concerns within Threadneedle Street about the potential impact of normalisation.

He would focus on unit labour costs

The focus on the acceleration in wage growth this year is also more nuanced than the headline figures suggest. Yes, earnings growth rose above 3% (year-on-year) in April, but unit labour costs across the whole economy fell in the first quarter of 2015, due to stronger productivity. Companies are not facing strong pressure to pass on labour costs, because of the impact of this on profit margins.

Money supply growth remains modest

Moreover, he said, perhaps most significantly, broad money growth (M4ex measure) remains very moderate at 4.4% (year-on-year). This is still well below the 6% growth target pencilled in by the MPC at the outset of QE. Those with an eye for economic history will also note that in each of the 3 periods of monetary tightening over the past 30 years, broad money growth was always in double digits (13% prior to the November 1984 to March 1985 tightening, 17% prior to the June 1988 to October 1990 tightening and 13% prior to the August 2005 to July 2007 tightening). Of course, in the new normal, nothing is normal, but tightening monetary policy when broad money growth stands at just over 4%, would be a brave move and in his view, the wrong one.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate. QE on hold.
Bias: To raise Bank rate further in stages.

Bank rates of ½% are not normal and should start to be reversed

Zero inflation, let alone negative inflation is not a normal state of affairs given UK post-war economic history. Neither is a Bank Rate of ½% for the length of six years. The arguments for the continuation of low interest rates are almost like those riding the wave of a speculative bubble, except in reverse. Everyone knows that interest rates have to rise sometime and the consensus is that the Bank of England would start to raise rates in the first half of 2016. The Governor’s prompting at the Lincoln speech was the first signal of official preparation of the markets that a gradual rise will come in the turn of the year. While some might continue to argue that interest rates should rise only when inflation starts to rise, or when the economy starts to show more robust growth, or when the euro-crisis abates. None of these will happen in the near future. Inflation may still continue to bump along at current rates for a further 12 months. The economy will continue to grow but productivity will remain weak. The euro has stepped back from the precipice but the fundamentals have not changed. The political imperative dominates a failed economic experiment and Greece will once again slide back towards the edge. Ultimately the euro-crisis will re-emerge in some other form, if not next year, then the year after.

NAIRU may have been breached, and the fall in unemployment has reached its limits

Macroeconomic fundamentals may appear benign but the flattening out of the rate of unemployment (slightly up in March-May) and the 0.5% capacity assumed by the Bank of England point to the neighbourhood of an equilibrium once called the NAIRU that may have been breached. An outward shift in the Beveridge Curve (the vacancy-unemployment relation) may point to a structural problem in the labour market which suggests that the fall in unemployment has reached its limit. Average earnings growth, while rising remains low but with productivity growth at near zero, it is certain that at some point when the special factors that have driven inflation to what it is now wear out, that this is reflected in inflation. The signal for the turnaround in rates will occur with the Fed raising interest rates. The macro arguments for retaining rates at the current ½% are weakening.

Low productivity can only be addressed with supply side policies… low interest rates cannot solve it

The fundamental problem for the UK economy is its low productivity growth. This is a microeconomic problem of low investment and can only be addressed through a supply-side policy, which includes a low expected tax liability based on tight fiscal policy, reduced government debt, and a receding government sector providing room for private sector growth. In addition, the financial repression resulting from low Bank rate along with the tightened regulatory regime, has caused a severe misallocation of financial resources with high growth firms being starved of funds and Zombie firms surviving on cheap credit. Low interest rates do nothing to solve the microeconomic problem and even exacerbate it by delaying the adjustment of the flow of funds from low productive to high productive enterprises.

The Bank can restore its credibility by being ahead of the curve, moving before the Fed, and signal the start of the rise in rates.

Vote by Patrick Minford

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

Greek lenders 'to extend and pretend'

The Eurozone crisis has now been going on for about five years and the latest Greek episode has drawn attention away from the initial signs that it might be coming to an end. It still remains likely that the usual 'pretend and extend' strategy will happen once more with Greece after next Sunday's strange referendum. It seems that the Greeks will vote Yes to the 'latest package' outlined in the referendum document and that the rest of Europe will put it back on the table and agree it with a great sigh of relief. The Tsipras government will argue that their mandate has altered in the light of this Yes vote and will continue in power, 'implementing' it. So the Eurozone will go on lending Greece huge amounts of money and pretending that it will be repaid. Some sort of normality will return to the Greek economy.

Weak recovery is underway in Europe, helped by QE

Probably the Eurozone will continue with its weak recovery after this. The Quantitative Easing programme being pursued by the ECB, which is comparable in its effect on M0 with both the US and UK programmes, is having some observable results in terms of money growth, with M3 growth now reaching 6% on a year ago. The banks are heavily regulated and have reacted by shrinking their balance sheets, particularly loans to SMEs. In the Eurozone, furthermore, banks are weakened by large holdings of government bonds of Southern European countries struggling with solvency problems; 'stress-testing' these banks is asking for trouble. Nevertheless something of a rebound is now occurring under the impact of QE.

Unfortunately it is hard to see when if ever 'glad confident morning' will arrive in the Eurozone, so deep are the problems created by the euro for handling the sort of crisis that has erupted. Having willed the euro for political reasons, the politicians now are unwilling to allow the solidarity in economic affairs that might just make the project possible. Governments find cooperation hard or even impossible because their home opinion is hostile to it; hence the issuing of bonds jointly guaranteed by all euro-zone governments is essentially off the table. This leaves all the heavy lifting at the euro-zone level to the European Central Bank. But it too is riven with dissent, with the German members and its allies unhappy with QE.

This will help the UK, which is lucky not to be in the Euro

Where does this weak but recovering background in the Eurozone leave the UK? In the first place the Chancellor and the Treasury will be pleased that, instead of negative or zero growth across the Channel, they are looking at some positive growth. In the second place, it injects a sombre note into the debate over the UK referendum on Europe. No one can pretend any more that we are in some seriously dynamic geographical partnership whose absence would be much of a loss. The arguments over this regional relationship will be carried out within a realistic perspective, rather like those over joining the euro - also a regional (monetary) relationship, which, mercifully, we did not join as it, would have dragged us down with the rest.

UK recovery is not dependent on Europe but on willingness to innovate, compete and embrace industrial

There is a wide reassessment of European prospects going on in investment circles just as there has been of Japanese prospects since the early 1990s collapse in asset prices. Sometimes areas of the world go ex-growth. Just as this happened in Japan, so it has now happened in the Eurozone. The reasons are similar: falling population, rising average age, strong vested interests with voting power, but with the added stress in the Eurozone of currency dissension.

Fortunately growth in an economy does not depend on the neighbours but on its own intrinsic dynamism, which comes from willingness to allow competition, innovation and industrial change. The UK has established this willingness by its reforms in the 1980s and 1990s, which in turn were accepted politically by the Blair government in the 2000s. The coalition government was also united in support of this approach and it is continued by the Conservative government. The defeat of Labour and its various left-wing allies - the SNP, Plaid and the Greens - underlines how economic success along the lines of this approach remains the dominant view of the British electorate. The Scottish and Welsh electorates do not share this view locally but this is only because they are afforded the luxury of doing so by English taxpayers - without their support they would have to raise taxation by 12-15% of GDP in Scotland and some 20% of GDP in Wales. When one considers that after huge efforts in revenue raising the UK ratio of revenue to GDP is still only 36%, it puts these figures into perspective. Scotland and Wales on their own would have to increase the size of their revenue raising engines by between one third and more than one half just to afford current spending rates, let alone dreams of a socialist state.

This has meant electoral success for those parties who embrace this approach

The political conclusions from this are plain. Labour has no future in government unless it readopts its old Blairite approach. Furthermore, there is absolutely no prospect of either Scots or the Welsh voting for independence; they will continue to agitate for as much devolved powers as they can get but they have no bargaining power with England over the matter. When there are no borders, there is no real power to set separate rates of tax; nor can there be much independence in 'how to spend it' since equally people can vote with their feet if denied competitive public services. The argument over devolution is therefore a meaningless charade.

This is good news for UK growth and for a future in which increasingly the UK charts a different policy course from the socialist/social-democratic consensus of the Continent.

Process of normalisation of rates should start to head off next crisis

This also means that monetary policy should return towards normality sooner rather than later, as the growth in wages reflects the UK's increasingly tighter labour market. 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.

Vote by David B Smith

(Beacon Economic Forecasting)
Vote: ¼% rise in Bank Rate.
Bias: To raise another ¼% in November.

Was the July Budget a Conservative one?

David B Smith opined that it would have been better not to have had a July budget from an economic perspective. The fiscal projections in the March Budget seemed reasonably on track, for a change. Holding two Budgets within a few months of each other simply exacerbated the uncertainties facing business and discouraged growth-enhancing private capital formation. He thought the Budget might, arguably, be classified as Conservative, but only if Conservative was interpreted in the sense of the former Prime Minister Edward Heath, or the 18th Century Bourbon monarchs of France and Spain. What it was certainly not was a liberalising budget in the Gladstonian sense, or Conservative as in Lady Thatcher or the post-War Churchill administration. Churchill in the 1950s and Thatcher in the 1980s had rolled back the frontiers of state intervention and tried to reduce taxes whereas Mr Osborne has generally failed to achieve his spending targets and raised and complicated taxes. Perhaps, Mr Osborne should be considered a 'Big-Government Conservative' in the sense of the former US President George W Bush, whose policies badly damaged the US economy before the Global Financial Crash.

Drawbacks of the living wage

The introduction of the National Living Wage, in particular, was a reversion to the medieval concept of a just price and would price out of employment a lot of people in the poorer and cheaper parts of the UK where educational standards and individual productivity were often low. The living wage would also hit female employment prospects in sectors such as retailing disproportionately, unless other aspects of the wage bargain where changed. In the event, there were already signs that retailers were preparing to abolish popular perks, such as staff discounts, in order to pay the additional wages to their staff. There was also the question of staff in Local Authority care homes where higher wage costs would add to the pressures on already hard hit Local Government budgets. Before the Budget announcement, the UK's minimum wage had been around the middle of the European distribution. However, Mr Osborne's target would take Britain very close to the top alongside France and Slovenia.

Budget worsened supply/demand balance, strengthening the case for a rate hike

More generally, the July Budget represented a missed opportunity for the government to nail some supply side colour to its mast by cutting the top rate of income tax and simplifying the ridiculous roller coaster of marginal tax rates that exists once allowance is made for the interaction between tax credits, national insurance contributions and income tax. This would have made the

UK one of the most attractive homes for capital investment in the developed world and would have been similar in effect to the big-bang reforms carried out in the more successful former Eastern European economies, such as Poland and Slovakia. In sum, the overall effect of the July Budget, compared to the one held in March, was to raise both public spending and the tax burden. This represented the opposite of the policy required to boost aggregate supply and ameliorate the twin deficits. As a consequence, Mr Osborne had altered Britain's macroeconomic supply/demand balance unfavourably in a way that strengthened the case for a hike in Bank Rate. Finally, David B Smith drew attention to the new Bank of England procedures that would be implemented in August with the simultaneous release of more information about the MPC meeting. He thought these proposals should usefully improve transparency but might be difficult for City economists to instantly respond to. The first quarter growth figures suggested that the UK economy was stronger cyclically than the US and that the UK authorities need not wait for the US authorities to go first before raising rates.

Vote by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%.
Bias: To raise rates to 1½% over the next 12 months.

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

There is a growing amount of evidence that the MPC has misjudged the degree of tightening in the labour market in terms of its capacity to deliver an acceleration of wage inflation and to undermine the sanguine expectations of inflation over the coming year. The pattern of labour market development has been towards a slowing in the pace of headcount growth with some consolidation from part-time employment and self-employment back into full-time employment. This has been associated with the strength of the labour market manifesting in wage growth rather than employment growth for the first time for some years.

The MPC has exercised far too much discretion in the build-up of labour market strength and is now in danger of being seen by the financial markets to be too slow to respond. Indeed virtually any MPC sitting between 1997 and 2007 would surely have responded to the various signals from the product labour and housing markets that we have seen over the past 2 years, and would have raised rates. Having given cause for concern that the economy was slowing in the early part of the year, those concerns are now allayed. As Jamie Dannhauser showed in his presentation, there is persuasive evidence of a new momentum building in the housing market and in the desire to own houses by young adults. I think there is no good reason to delay a Bank Rate increase and my vote is for an immediate increase of 0.25% and with an expectation that rates will continue to rise over the coming year to 1.5%.

Vote by Trevor Williams

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

The rise in average earnings was unlikely to last as firms will react by reducing hiring

Trevor expressed the view that, while tightening was becoming a more justifiable decision, he was concerned that employment growth would slow, and this would be worsened by the announcement of the higher minimum wages implied by the National Living Wage. His view is that we should give growth a chance and that the growth in real earnings and the growth of consumer spending, whilst they're encouraging, were not yet as well-established as the commentary seems to suggest. Why should wage inflation grow at 3% when price inflation is low, and likely to remain around zero for the remainder of the year? This implies a cut to profit margins that firms seem unlikely to acquiesce in without a fight. It also seems contrary to the grand bargain in the UK between employers and employees, with potential employers willing to take pay cuts or negligible pay rises as a price for being in a job. This is has served the UK well. Limits of 1% to public sector pay growth will be an influence over the years ahead. Moreover, he thinks that the consensus is far too optimistic about U.K growth, given the potential for disappointment in global economic growth.

Inflation is negligible and data do not support rate rise

He is concerned about the lack of sustained productivity growth, the vulnerability this suggests for the economy in the medium term and the risk that UK growth might be derailed by the ongoing European situation, including Greece and Ukraine. The conclusion being that the UK should not be hiking rates at the moment and that any increase of rates should be data dependent. As such, he argues that the data, current and forward looking, does not justify a rate hike at this moment.

Policy response

1. On a vote of five to four the committee agreed to hold the Bank Rate at 0.5%.
2. As last month, two members voted for a rise of ¼%, one for ½% and one for an increase of any size.

Date of next meeting

Tuesday, 13th October 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), Graeme Leach (Legatum institute), Andrew Lilico (Europe Economics and IEA), Patrick Minford (Cardiff Business School, Cardiff University), 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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