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# IEA Shadow Monetary Policy Committee

## October 2015

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## **Shadow Monetary Policy Committee votes five / four to raise Bank Rate in October.**

In its latest email poll, the Shadow Monetary Policy Committee (SMPC) voted to raise Bank Rate by 0.25% in October, the second consecutive month it has voted for an increase. The vote came against the backdrop of the US Fed leaving rates on hold, citing China as one reason.

Those voting for a rate hike continue to warn - amongst other things - that in any future economic slowdown, the UK would not have the flexibility to respond by cutting rates if they are not raised soon. One argues that recent data revisions show that there is no negative output gap in the UK, and that is why earnings growth is rising so quickly, a sign that monetary policy is too loose. Those voting for unchanged rates continue to cite little price inflation in the actual data, slow growth in monetary statistics and signs that the economy may be losing momentum.

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 1<sup>st</sup> November and 6<sup>th</sup> December 2015, respectively.

## **Vote by Roger Bootle**

(Capital Economics)

**Vote:** Hold Bank Rate.

**Bias:** To raise Bank Rate.

## **Vote by Jamie Dannhauser**

(Ruffer)

**Vote:** Raise Bank Rate by 25bps.

**Bias:** Further very gradual hikes in Bank Rate;  
no change in QE stock.

## **Vote by John Greenwood**

(Invesco Asset Management)

**Vote:** Hold Bank Rate.

**Bias:** Neutral.

**Consideration of the economic variables that impact inflation over two years is but part of the policy matrix**

There are two broad ways to consider whether the Bank of England should adjust interest rates. The standard approach is to make an assessment of all the economic variables that may influence the measured inflation rate over the forecasting horizon of two years (i.e. over the approximate time that it takes monetary policy decisions to affect output and inflation). The normal list of candidates for review would include: (a) activity variables such as the strength of economic activity and the size of the output gap, (b) indicators or pre-cursors of future inflation such as commodity price trends, import prices, producer prices, and wages, and (c) the state of inflation expectations either as measured by survey polls or by financial variables such as the forward swap curve and the difference between nominal and indexed gilt yields. The problem is that this approach omits a key set of variables: money and credit.

**We should not ignore credit and money**

The alternative approach is simply to consider interest rates as the price of obtaining credit, and to raise rates if credit is growing too rapidly, but to lower interest rates if credit is growing too slowly. Credit is generally created by banks when they make loans or other advances, and – with some qualifications – can in the short run be considered equivalent to the rate of growth of bank deposits, which in turn comprise the bulk of the broad money supply. In other words, credit growth can – generally -- be viewed as a reasonable proxy for the growth of broad money.

**The latter are growing too slowly to warrant a rate rise**

Currently it is hard to argue that either credit or money growth rates in the UK are too rapid. On the contrary, by most definitions these quantities are still growing at a sub-par pace by any historical standard. For example, in the twelve months to July M4 lending declined by 0.2%, M4 lending (excluding loans to intermediate OFCs) grew by just 2.3%, and M4 grew by a mere 0.6%. Only M4x, which grew by 4.2% over the 12-month period, is growing at anywhere near a normal rate. Given the 2% inflation target, growth rates of 6-8% p.a. for these variables would be more appropriate over the medium term.

**Consequently, I would leave rates on hold**

The current low growth rates of money and credit suggest there is absolutely no danger of any sudden outburst of inflation or any overheating of the economy. Indeed, it is the sustained low growth rates of these data over the past few years that are the fundamental explanation for the exceptionally low rates of inflation in the UK today. Commodity price changes, low consumer goods prices, and other supposed “explanations” are merely symptoms of the relative weakness of aggregate demand (spending) in the economy. Weak spending growth in turn is a direct result of inadequate money and credit growth. On the basis of these data it is not appropriate for the Bank of England to be raising interest rates at this stage.

### **Vote by Graeme Leach**

**(Legatum Institute)**

**Vote: Hold Bank Rate.**

**Bias: To raise rates.**

### **Vote by Kent Matthews**

**(Cardiff Business School, Cardiff University)**

**Vote: Raise Bank Rate.**

**Bias: To raise Bank rate further in stages.**

### **Vote and comment by Patrick Minford**

**(Cardiff Business School, Cardiff University)**

**Vote: Raise Bank Rate by ½%. Start to reverse QE.**

**Bias: To raise Bank Rate and QE to be reversed.**

**There is no need to panic over China...some slack in the world economy is not unnatural**

Unfortunately at present there is still a panic over China's problems. Yet consider the latest global data. World growth is running in the range of 3-4%. World trade is in the same range which is lower than usual relative to world growth (traditionally it has grown up to twice as fast). This may partly

reflect covert protectionism against goods trade in the face of the recent crisis but is probably mainly reflects 'reshoring' as opposed to 'outsourcing' as Chinese costs have risen with ageing and the drying-up of cheap labour. It may also reflect a shift to service trade which is less well measured.

**The world economy cannot always grow flat out**

Really, these rates of growth may reasonably mirror the growth and pattern of resource availability. It is one of the fallacies promoted by Keynesianism that the world economy should always be growing flat out, with no excess capacity and very low unemployment rates. Yet economies need to allow weak industries to contract and growing industries to find staff, land and capital. The 'natural' rates of unemployment and capacity utilisation take into account existing misallocations of capital, labour and land; creating stimulus via fiscal and monetary policy is both potentially inflationary and can prolong the misallocation. It also needs to be remembered that misallocation includes the degradation of the environment, especially obvious in China but also occurring in other emerging market economies.

**But seem likely to put off a rate rise**

The latest panics look set to put off the raising of interest rates yet again. However the dangers of leaving 'QE' assets dormant in central banks are acute. Calls are being made by Corbynomists for QE to be used as a printing press in place of bond issue, specifically to pay for infrastructure investments. This is fiscal deficit spending financed by printing money- a totally toxic idea, which was last tried by Edward Heath's Conservative government, with massive inflationary consequences. It was due to that crazy period that we got first monetarism and then the idea of independent monetary policy set largely by the Bank of England to hit inflation targets. Inflation, we all finally discovered then, is a monetary phenomenon: Corbynomics would guarantee to bring it back.

**Printing money to fund a fiscal deficit would be toxic**

Also there are demands for the bonds held by central banks to be 'liquidated' by central government which owes them. This would hobble future monetary policy since the money printed under QE could never be liquidated; also any printing of more money would again amount under these terms to pure fiscal deficit creation.

**The Bank of England should start to reverse QE**

Given these pressures, now is the time for the Bank of England to begin selling off its bond portfolio, with a view to eliminating it over say two years. Leaving it as it is, with a view to letting the bonds run off on maturity, invites an ongoing debate on fiscal profligacy by the back door which we can ill afford to have.

In sum I would as before like to see interest rates rise, but even though this now seems unlikely in the very near future, I would certainly urge an immediate move to reversing QE by the sale of Bank bond holdings into the open market.

## **Vote by David B Smith**

**(Beacon Economic Forecasting)**

**Vote: ¼% rise in Bank Rate.**

**Bias: To raise another ¼% in November.**

## **Vote and comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: Raise Bank Rate by ¼%.**

**Bias: To raise rates to 1½% over the next 12 months.**

**Upward revisions to GDP show that the UK has no spare capacity**

Now that the Office for National Statistics has revised upwards its historical growth estimates for 2010-13 from a cumulative 4.1% to 5.5%, the supposition that the UK sports a negative output gap looks even less tenable. The assertion of a negative output gap is one of many spurious arguments advanced by members of the Bank's MPC in support of the ultra-easy stance of UK monetary policy over the past 2½ years. The assertion of labour market slack is another: average earnings growth in the private sector has reached its quickest pace for 7 years.

**Analysis of the impact of China's growth on the US and UK shows that its effect is very small**

The latest bogeyman to appear on the global horizon is "concerns about China's economic growth", given added credibility by Janet Yellen, chair of the US Federal Reserve Board, at the post-FOMC press conference on 17 September. An analysis of the OECD's Trade in Value Added database undertaken by my colleague Graeme Chamberlin reveals that only 8% of UK GDP depends on the final demand of emerging market nations. In the specific case of China, the impact is less than 2% for the UK and closer to 1% for the US. It makes no sense to defer policy tightening in either US or UK for fear of slowing growth in China. The potential impacts are just too small to warrant such concerns.

**We should be more worried about a global slowdown in 2 years' time driven by other factors and start to raise rates to create room to cut**

However, it is not fanciful to suppose that a global economic slowdown will hit in 2017 or 2018, for a host of reasons (eg a new default cycle in corporate debt) other than a deceleration in China. A failure to raise UK interest rates materially in 2015 and 2016 opens the possibility that a new downturn may arrive while policy interest rates remain extraordinarily low, offering little scope for policy to be eased at that time. The future costs of leaving interest rates unchanged are mounting. The tightening of UK monetary policy is long overdue. My preference is for an immediate Bank Rate rise of 0.25%, with a minimum target of a 1.5% Bank Rate by end-2016.

## Vote and comment by Trevor Williams

(Lloyds Bank & Derby University)

**Vote: Hold Bank Rate.**

**Bias: Neutral.**

**The UK's economic data are showing signs that activity has peaked**

In the past month, economic news has been mixed. Growth was left unrevised at 0.7% in Q2 but the year on rate was revised lower, from 2.6% to 2.4%. Over the period 2010 to 2013 growth was revised up by a cumulative 1.4%, but productivity was also better so that the implied inflation effect was negligible. Meanwhile, the data for Q2 showed that the recovery was becoming more unbalanced with all of the recovery coming from services, with manufacturing and construction contributing little.

**High frequency data show a slowdown in manufacturing is underway**

More recent data show that manufacturing output fell by 0.8% in July and was 0.5% lower than in the year before. Construction output fell by 1% in the same month, and was 0.7% lower year on year. Survey data suggest that further slowdown may lie ahead. Volume retail sales were up by 0.2% in August but the 12-month rate slowed from 4.2% in July to 3.7%. Not surprisingly, NIESR's GDP estimate for the three months to August showed a rise of 0.5%, down from 0.7% in the preceding three month period.

**Inflation is still weak**

Inflation remains muted, falling from an annual rate of 0.1% in July to zero in August. The early data suggest a fall of 0.1% or so is on the cards when the September data are released, further below the 2% target. Producer input prices fell by 2.4% in August and were 13.8% below the previous year's level. Firms' output prices were down 0.4% in the month and 1.8% below the year before.

**Money supply data are consistent with an unchanged Bank Rate**

Meanwhile, money data do not suggest that inflation will remain anything other than weak. Headline M4 money supply for August showed a fall of 0.4% to stand 0.1% lower than in the year before. M4ex, on a 3 month annualised basis, was up by 2.2% in August but slowed sharply from 3.7% in July. With price inflation looking set to stay low, the economy's momentum flat at best, signs that productivity may at last be picking up and monetary data lacklustre, I would leave rates on hold and QE at £375bn.

## **Policy response**

1. On a vote of five to four the committee agreed to raise Bank Rate to 0.5%.
2. Of the five that voted for an immediate rise, four voted for a rise of  $\frac{1}{4}\%$ , and one for an increase of any size. Therefore, on our voting methodology, the vote was for a rise of  $\frac{1}{4}\%$ .

## **Date of next meeting**

**Tuesday, 13<sup>th</sup> 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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