
IEA Shadow Monetary Policy Committee

November 2015



Institute of
Economic Affairs

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

Reversing the last two months of narrow votes in favour of a rate rise, the Shadow Monetary Policy Committee (SMPC) voted to hold Bank Rate by five to four at the physical meeting held in October. One member changed his vote from a rise to a hold. This highlights how narrow the decision remains.

A worsening of the international economic backdrop, the fall-back in price inflation, weak credit and monetary growth and signs of a slackening in the pace of UK domestic economic expansion was enough in the view of the majority to hold Bank Rate at 0.5% in November.

The four members that wanted to lift rates cited the distortions caused to savings and investment behaviour in the UK by interest rates being kept too low for too long and the risk of wage inflation becoming embedded. It was also so felt that current rates of monetary growth were consistent with recovery in a low inflation environment and that keeping rates at an emergency low when the economy had already passed its pre-crisis peak demonstrated a lack of confidence in the recovery.

It is noteworthy that six of the nine Shadow Policy Committee members that voted had a bias to raise rates, and none had a bias to ease. In contrast, in the same month that the meeting took place, the European Central Bank (ECB) announced that it was thinking of further easing, including QE, and the Bank of China actually cut its interest rates.

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 December 2015 and 3rd January 2016, respectively.

Minutes of the meeting of 13th October, 2015

Attendance: Jamie Dannhauser, Anthony Evans, John Greenwood, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David B Smith, Peter Warburton, Trevor Williams (Chairman), Roger Bootle (arrived 17.20), Tim Congdon (arrived 17.55).

Observer: Andrej Kolomijec (IEA Intern)

Apologies: Graeme Leach, Mike Wickens, Akos Valentinyi.

Chairman's comments

The Chairman, Trevor Williams, thanked those in attendance for making the meeting, and then invited Andrew Lilico to present the monetary situation.

International Background

Improving advanced economies but weakening China.

Andrew Lilico distributed a paper entitled 'Background to SMPC Decision'. He began with the world economic background. He said that the global picture is one of faster growth in the advanced economies and slowing growth in China. The OECD leading indicators were moderately positive for the Eurozone, negative for all major economies, and very bad for China. However, unemployment in the advanced economies had stabilised.

Money growth was picking, broadly.

Broad money growth in the USA and Japan had been stable, but on the positive side money growth in the Eurozone had picked up sharply. However, there remained much uncertainty in the global scene. Sovereign bond yields have been more volatile in 2015. Commodity prices had stopped falling and had even reversed in recent times.

UK background

Revised GDP data stronger.

Turning to the UK, GDP growth on the revised figures had been steady since 2010, except for a mild slowdown in 2012 and a strong upturn in 2013. The Bank of England expected that growth will be stable to slightly slowing over the next few years. However, the Producer Confidence and Consumer Confidence indices have been decreasing in the year. Both CPI and RPI inflation were well below target and with CPI, the latest figure showed there was deflation. The Bank of England projects inflation returning to, or above, target over next three years.

GDP growth steady but no response from broad money growth.

Although growth has been steady, there had been no response in broad money or bank lending growth. Annual M4 growth was at zero and the year-on-year rise M4-ex was around 3.8%. Gilt yields remain at low levels with a slight downward trend, but the pound has strengthened on the effective exchange rate. The PMI services index was signalling a slowdown but overall all three indices (Construction, Manufacturing and Services) still remained healthy.

Summary

Domestic political, international and monetary risks high.

The risks over the policy horizon of two to three years could be separated into the three areas of domestic political, international, and monetary risks. Domestic political risks included, investor flight in response to the Brexit referendum period, the negotiation period in the event of a vote to exit, and opinion poll leads for a Corbyn-led Labour government. International risks, included the escalation of the conflict in Syria, the slowdown turning into a sharp downturn in the Chinese economy, and finally the re-emergence of the Eurozone crisis. Monetary risks related to the rise in US interest rates and losses in emerging markets that may trigger a new financial crisis for European banks.

Below target Inflation was temporary.

In summary, Andrew Lilico said that the UK economy was expected to grow steadily, with low unemployment and near-zero inflation. The current below-inflation target experience was temporary as oil prices stabilised and even, possibly, rose. Monetary growth remained low, but there had been no change on this for the past two years when GDP growth had been around 3% a year. Some risks remained, but nothing urgent.

Rates should have risen earlier.

In conclusion, Andrew Lilico said that in the absence of any strong argument for rates to remain low there should be a drive to normalise. However, having reached this point, he felt that it was best to let things ride. So, he recommended that rates be put on hold. In the US, the response of consumer demand to the dramatic fall last year in the oil price had been less positive than expected. In particular, there was much greater weakness in the first quarter of the year than had been anticipated.

Discussion

Why should rates remain on hold?

Trevor Williams thanked Andrew Lilico for his excellent presentation and opened the meeting out to general discussion. Patrick Minford challenged Andrew to explain the logic of his hold recommendation just because inflation was temporarily negative. Andrew Lilico said that having rates at this level for so long meant that there had to be some movement in inflation to warrant a change in policy. Kent Matthews asked him to clarify if he meant measured inflation or expected inflation. Andrew said that there was little concrete evidence that inflation will rise materially above target any time soon.

QE implication for unconventional credit growth.

Patrick Minford asked if QE had had any effect on liquidity and the development of alternative funding sources such as P-2-P. Also he asked how much did it add to the money supply? Andrew Lilico suggested that the banks may not have responded to QE as expected because of the toughening of the regulatory environment. Roger Bootle said that the Creditist channel mattered. But, if the effect on the money supply was minimal, the re-arranging of funding sources implied that the velocity of circulation had increased. Andrew Lilico said that P-2-P was like near-money. John Greenwood said that the historical development of the euro-dollar markets, the growth of shadow banking, and currently P-2-P as liquidity creating entities had similar causes. Also with the first two, the growth would be amplified relative to observed monetary growth; meaning that the growth in euro-dollar deposits and shadow bank lending would rise faster than money growth in the upturn and fall faster in the downturn. However, P-2-P was small compared with the size of M4.

Regulatory upheavals.

Patrick Minford suggested that the regulatory upheavals experienced by the banking sector will have disrupted established relationships and it was clear that the banking system had contracted its asset creation particularly in relation to SMEs.

Financial repression and high cost of borrowing for SMEs.

David B Smith said that the annual increase in the Office for National Statistics (ONS) measure of the volume of market sector output growth had accelerated from 0.7% in 2012, to 2.3% in 2013 and 4% in 2014 but had eased this year to 3.5% in 2015 Q1 and 3.1% in the second quarter. He added that this looked disturbingly like a classic pre-election boom. Trevor Williams said that, given the potential impacts in 2016/17, how does this fit in with the current picture of long term bond yields? Patrick Minford said that bond yields were not the issue and that financial repression and high borrowing rates for financially constrained SMEs was the issue. Roger Bootle questioned the necessity of bank lending increases for the financing of growth. He said that households were saving and large corporations are sitting on large surpluses. Trevor Williams said that Lloyds had set aside significant amounts for new lending to SMEs. Jamie Dannhauser said that sector churning

had been re-established in a massive way with cross-sector lending. Andrew Lilico suggested that there were phases of investment that may not be properly measured.

Continued de-leveraging explains low money growth.

John Greenwood said that de-leveraging was still continuing and monetary policy was not easing in the sense of faster broad money growth. Lending constraints had continued with tighter lending standards. People were reluctant to borrow with as much as 10% of US mortgage borrowers still in negative equity. Trevor Williams agreed that one explanation for the low growth of broad money was the continuation of deleveraging and debt repayment. Peter Warburton said that credit conditions are multi-causal. He noted that mortgage rates had fallen but mortgage volumes had not increased significantly.

What explains low gilt yields?

Andrew Lilico asked for an explanation for the downward trend in gilt yields. He said that gilt yields have become poor indicators of risk-free rates. Patrick Minford said that an average of yields on all assets should be used as a measure. Yields have been distorted by the volume of central bank holding of government bonds and that monetary policy had distorted the costs of funding to the government.

Trevor Williams brought the discussion to order and invited the committee to make their individual representations. As Tim Congdon was the last person to arrive and following the convention for oversubscribed attendance to votes, Trevor Williams asked Tim to give his views which will not be counted for the votes and that, as Chairman, he would abstain.

Money growth was low in most countries.

Tim Congdon said that money growth was low in most countries. China did not want to squeeze the banks further. In the USA, small banks were being favoured by the regulatory authorities but there was a general clampdown on the larger banks and the banking system. Basically, the economy was moving forward steadily. He said that the Bank Rate should remain on hold.

Trevor Williams then invited members to vote.

Growth in exotic investment vehicles.

Vote by Roger Bootle

(Capital Economics)

Vote: Hold Bank Rate.

Bias: Raise.

Roger Bootle said that there was no hurry to raise rates. Inflation would rise when commodity prices stabilised and started to rise. The distortionary factors mentioned in the discussion were relevant but the economy had grown all the same. He said that he was concerned about the commercial property market that was looking overpriced. He said that he was also worried about the growth of exotic investment vehicles such as vintage cars, fine wines and art that usually occur because of distortions to conventional investment markets, suggesting just such a distortion now. He voted to hold interest rates with a bias to rise.

Case for raising rates has not been stronger since the crisis.

Vote by Jamie Dannhauser

(Ruffer)

Vote: Raise Bank Rate ¼%.

Bias: Neutral.

Jamie Dannhauser said that the case for raising rates was stronger now than it had been since the crisis. The economy had experienced three good years of growth and he was now concerned about the labour market data. He said that the labour market had begun to register recruitment problems and that higher wage growth was coming through the system. The global backdrop was worrying, particularly the developments in China, but the balance of macroeconomic risks warranted a rate rise.

Low rates embedded in system.

Vote by Anthony Evans

(ESCP Europe)

Vote: Hold.

Bias: To reverse QE.

Anthony Evans said that the costs of maintaining low interest rates for so long have embedded in the system such that the burden of the argument is now on those who want to change rates. The problem with an inflation target is that it ties the hands of policy. Credibility issues relating to the inflation target mean that policy has to be consistent when inflation is below target as well as above. He said that the base rate should stay on hold but that if inflation remains below target he would consider tightening monetary conditions through the reversal of QE.

Vote by John Greenwood

(Invesco Asset Management)

Vote: Hold Bank Rate.

Bias: Neutral.

No inflation threat.

John Greenwood stated that monetary growth was very low and that there was no imminent threat from inflation. He said that talk of risks from a wage-inflation Phillips curve was overdone. The initial effect of wage inflation will most likely be a shift in the composition of national income, implying a reduction in profit margins. Productivity was weak because corporates were not willing to spend their surpluses. He voted to hold rates with no bias.

Vote by Andrew Lilico

(Europe Economics)

Vote: Hold.

Bias: To raise Bank Rate.

Interest rates should have risen earlier.

Andrew Lilico said that it was arguable that rates should have been raised much earlier. But the economy had still grown. At this point in time, when there was actual deflation, the inflation target demanded a consistency in policy, which meant that rates must stay on hold. He said, however, that he had a strong bias to raise rates.

Vote by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Hold.

Bias: To raise Bank Rate.

Despite financial repression, SMEs are obtaining funds.

Kent Matthews said that he had argued in the past that the decision to raise rates was a balance of microeconomic arguments over macroeconomic ones. He agreed with the discussion concerning financial repression and the allocative inefficiency that arises from it. But he was also impressed with the arguments that despite the inefficiencies caused by financial repression, the economy had managed to grow at a healthy rate and, following the discussion of the meeting, it was also clear that somehow SMEs were securing funds, albeit at a high external finance premium. Therefore, the allocative inefficiency may not be as restrictive as he originally thought. The reality was that real interest rates for borrowers was positive and high, but real rates for savers were low and needed to rise soon.

Inflation target should be treated symmetrically.

He said the argument that the credibility of the inflation target mechanism required below target outcomes to be treated in the same as above target outcomes, is less impressive. The Bank failed to act when inflation was above target and had lost credibility anyway. The argument now was one of balancing the macroeconomic losses against the microeconomic gain from a rise in rates. It was much harder to sell the argument that interest rates should be raised on the day that the CPI recorded a fall in the price level. He felt that, on balance, the short term argument for keeping rates at the current level won over the medium term one that the rate of interest needed to rise to bring the economy back into balance. However, rates need to rise at the earliest opportunity.

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%.

Bias: To raise Bank Rate.

Macroeconomic policy distorted by regulatory burden.

Patrick Minford said that if not now, then when? Monetary policy had been distorted by the regulation burden and what we were facing was not a macroeconomic problem but a microeconomic problem. There was a need to raise rates because private sector saving faced an unfavourable environment and was not working well. The distortion had to be addressed immediately with a rise in rates.

Vote by David B Smith

(Beacon Economic Forecasting)

Vote: Raise Bank Rate by one-eighth.

Bias: To raise Bank Rate.

Expectations of a gradual rise in rates need to be created.

David B Smith said that the ONS had released lots of new and substantially-revised data on 30th September. The new figures showed that growth from the crash up to last year had not been as weak as was originally thought but that the growth figures for 2015 Q1 and Q2 were slightly weaker. The new ONS figures for the balance of payments also showed a somewhat better picture. However, he wondered how long the Chancellor could maintain fiscal credibility, given the sluggish pace at which the budget deficit was coming down and Mr Osborne's consistently over-optimistic forecasts in this area? With zero inflation, the growth in real M4ex broad money balances had been significant and consistent with further recovery. However, he added that increased financial regulation had meant international trade finance had been a problem that was holding back the growth of world trade. He said that he had recently attended conferences where he had heard former MPC members discuss the need to raise rates in very small steps of less

than one-quarter point and that it was the complete trajectory of rate changes that mattered rather than the spot decision on just one date. He said that he could see the logic of this position and added that he would like to see a rise of one-eighth now and a further one-eighth by next February.

Vote by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate $\frac{1}{4}\%$.

Bias: To raise rates to $1\frac{1}{2}\%$ over 12 months.

Holding rates is a vote of no confidence in the economy.

Peter Warburton said that the burden of proof rested with those who argued against a rate rise. He said that rates should return to $1\frac{1}{2}\%$ - 2% over a period of 12 months. A real rate of interest is about resource allocation and the balance of saving and investment. Those who argue that rates should stick are making a vote of no-confidence on the economy. He said that rates should rise and keep rising in stages.

Comment by Trevor Williams

(Lloyds Bank & Derby University)

Vote: Hold.

Bias: None.

Trevor Williams said that for completeness he would give his view although it would not be counted in the vote. He said that rates should be on hold but he agreed that there was a problem of distortions in capital markets. But with global inflation pressure weak, and domestic prices rise so far below target amidst signs of slowing growth, there was time to wait to see how the economy developed before acting.

Policy response

1. On a vote of five to four, the Committee agreed to hold Bank Rate at 0.5%.
2. One member voted for a rise of $\frac{1}{2}\%$, two for a rise of $\frac{1}{4}\%$ and one for one-eighth.

Date of next meeting

Tuesday, 12th January 2016

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 IEA *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)qw, 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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