
IEA Shadow Monetary Policy Committee

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

At its April 2016 face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of seven to two, to raise rates in May.

Members favouring a rise had a range of reasons for doing so, including the general sense that the economy was robust enough for some normalisation, that keeping rates too low for too long is likely to induce distortions in the economy which will be damaging over the longer-term, and that the fall in sterling is likely to mean increased inflationary pressures. It was not felt that the Brexit referendum is a valid reason for delay.

Those favouring a hold suggested that the economy is not robust and that tightening at this point could exacerbate, rather than address, underlying issues in the economy. There was also some suggestion that a range of supply-side issues will continue to provide deflationary pressure even with higher oil prices.

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 12th June and 10th July 2016, respectively.

Minutes of the meeting of 12 April 2016

Attendance: Jamie Dannhauser, John Greenwood, Andrew Lilico (Chairman), Patrick Minford, David B Smith, Akos Valentinyi, Peter Warburton and Trevor Williams.

Apologies: Philip Booth (IEA Observer), Roger Bootle, Tim Congdon, Anthony J Evans, Graeme Leach, Kent Matthews (Secretary) and Mike Wickens.

Chairman's comments

Trevor Williams welcomed everyone to the meeting and handed over the Chairmanship to Andrew Lilico. Andrew invited Jamie Dannhauser to present the monetary situation.

International background

China remains a concern

Jamie Dannhauser examined the international situation, noting that the loss of momentum in global economic activity that was observed in Jan/Feb this year has been arrested, but that the central narrative of gradually slowing trend global growth is unchallenged. China in particular remains a concern, but Chinese economic growth (using an estimate of underlying activity) has rebounded to an estimated 5% annual pace. Aggressive expansion of China credit contrives to divide opinion concerning the imminence of the threat to global financial stability.

Concerns about a UK recession have eased

The abatement of the spike in the high yield corporate credit spread in the US has eased concerns of an imminent US recession. Jamie noted that the most recent meeting of the US Federal Reserve had triggered a repricing of US interest rate expectations such that, an increase in the Federal funds rate of only 50 basis points was expected by the end of 2016, whereas, at the start of the year approximately 100 basis points had been priced in.

Credit conditions in the Eurozone have relaxed

There is an ongoing relaxation in Eurozone credit conditions, confirmed in the meeting of the European central bank on 10th March. These conditions remain supportive of real economic growth, with a suggestion that the growth maybe under reported. The global composite purchasing managers' index is currently stable at about 54, suggesting that the modest pace of growth was continuing.

UK Monetary Situation

2015 finished on a high note for UK growth

Jamie presented a quarterly growth chart of UK output and private domestic final sales growth to demonstrate that although the overall pace of growth had slowed in 2015 from a strong 2014, the final quarter of 2015 was a better quarter than the previous three. 2015 finished on a high note.

The UK jobs market is strong

Retail sales growth also picked up in the first quarter of 2016. Examining the unemployment data, survey evidence suggests an even faster pace of job growth than that shown in official data. There were ground for concern about the underlying pace of capital expenditure growth based on CBI indicators. The influence of the upcoming UK EU referendum is widely believed to be responsible for an increase in business uncertainty and postponement of spending decisions.

UK GDP may have been underestimated

A Goldman Sachs composite indicator of economic activity suggests that there may be some under estimation of official GDP over the past three years. Since the beginning of 2016, the UK interest rate curve has shifted significantly downwards to the extent of around 100 basis points. Essentially, the first increase in the Bank Rate from its current level of 0.5% has been pushed three and half years into the future. This is attributed to concerns that the referendum might deliver an exit conclusion but also reflects the abandonment of the narrative that had been constructed around a turn-of-the-year rate hike. The sole dissenter on the MPC, favouring a rate hike, has recently retracted his dissent.

Sterling has been fairly weak

Sterling has traded weakly in 2016, dropping around 10% in trade terms since 1st January. A credit conditions survey from the Bank of England suggests a very slight tightening in conditions from the latest survey. Turning to the monetary conditions in the UK, there has been a continued quickening in the pace of M4 money balances of households and non-financial companies. Jamie presented a chart that adds together these balances and also unused credit facilities and this shows a faster growth rate than the unadjusted data.

Bank leverage continues to fall

The leverage inherent in the UK banking sector continues to fall. The gross leverage of the UK banking system, measured as a ratio of total non-risk weighted asset to common equity, is back to fourteen times, which is its lowest level since the late 1960's.

Inflation remains weak

UK inflation trends have remained subdued with core inflation still very low at around 1%. There's been a downward drift in household's medium term inflation expectations to around 2.8% from the typical level of three or four years ago of around 3.5%. As the labour market has tightened, it has attracted more inactive workers or discouraged workers into employment. There is scant evidence of spare capacity in the economy

**There are argument
either way on rates —
arguments for leaving
rates unchanged...**

based on Bank of England agent scores and recruitment difficulties reported in manpower surveys. This is indicative of forthcoming pay acceleration. The decline in Sterling has begun to be reflected in rising Sterling input prices.

Turning to the policy discussion, Jamie examined both sides of the rates debate. The arguments for keeping rates on hold he listed as follows: first, that external risks remain elevated giving a downside skew to UK growth and inflation forecasts. Second, the observed rate of CPI inflation is still significantly below the 2 percent objective with little evidence of a convincing turn in the underlying pace of inflation. Third, that potential labour supply is very sensitive to aggregate demand growth. Fourth, that unit labour cost growth remains subdued despite recruitment problems. Fifth, that a marked rise in uncertainty suggests that economic growth is set to drop below potential. Sixth, that estimates of the sensitivity of demand to interest rates based on historic data may understate the impact of interest rate hikes. Finally, that fiscal headwinds are set to intensify through the remainder of this parliament.

**...and arguments for
raising rates**

Against these, he also listed arguments for raising rates and withdrawing monetary stimulus. These could be listed as first, that surveys suggest that there is limited or non-existent slack in the economy. Second, that indicators of marginal pay pressures are consistent with a tight labour market. Third, that money and credit data suggests that the accommodative monetary policy stands have gained sufficient traction, implying that monetary conditions overall are fairly loose. Fourth, sterling depreciation and the fall in market-based Bank Rate forecasts imply a large easing of the policy stance this year. This might require or be thought to require interest rate rises to lean against them. Fifth, growth in the UK's main trading partners is still moderate to solid and monetary policy cannot or should lean against potential growth risks in emerging markets and China in particular. Sixth, the employment data suggests official real GDP figures might understate cyclical strength. And finally, the strategic case that rate hikes should be early and gradual, rather than late and abrupt.

The Chairman thanked Jamie Dannhauser for his clear and informative presentation and opened the meeting to general discussion.

Discussion

Brexit will mean rate rises?

Patrick Minford expressed the view that were the UK to leave the European Union, after the June 23rd vote, then it was natural that interest rates should rise. The implied easing of a weakening exchange rate would presume that monetary policy should be tightened as an offsetting measure. Patrick thought we were moving to a point where we could have a much more conventional view of monetary policy. There has been excessive tightening through regulatory intervention, which was now turning easier. He noted that the stimulus from interest rates may be larger than currently perceived because of unmeasured or poorly measured indicators of peer to peer lending and other forms of credit activity. In other words, he asserted that monetary policy is more stimulatory than the official activity measures would suggest. Believing that the Brexit vote was likely to succeed and that Sterling is still vulnerable to a further sharp fall, Patrick argued that there is a need to tighten the stance of monetary policy pre-emptively.

...But would everyone agree?

Andrew Lilico raised the thought, which he believed might be offered by others even if not shared by those attending the committee on this occasion, that Brexit would induce greater uncertainty of economic outcomes and that to tighten policy pre-emptively or even in reaction to this would merely amplify this uncertainty. In time, Brexit would hopefully support supply side reforms and lead to an influx of foreign investment and a revival of investment intentions domestically. Jamie Dannhauser believed that there was a weaker case for raising rates than suggested by Patrick Minford, referring to the list of concerns that he had already presented.

Relative monetary policies are the key drivers of current movements, not the referendum

David Smith commented that the depreciation of Sterling reflects relative monetary policy and that it was the relative attractiveness of a particular country that was influencing the currency movements. Factors such as political confidence were important as well as financial or economic indicators. He drew attention to the potential for the law and order crisis in the European Union to erupt in time to have an impact on the outcome of the UK referendum. David thought that if the UK were to pursue sensible policies post the referendum the UK would attract capital and Sterling would recover.

Could Brexit mean sterling strengthens vs the euro?

Andrew Lilico highlighted the scope for Brexit to create instability in the European Union and for Sterling to be regarded as something of a safe haven from the Eurozone. He also mentioned the vagaries and uncertainties surrounding the outcome of the US presidential election in November, which again could create the circumstances in which Sterling would rebound in value.

**Fiscal tightening
continues to be
inadequate
tightening continues
to be inadequate**

David Smith commented that the fiscal tightening announced by Chancellor George Osborne in the budget was highly questionable. He thought that there was a lack of substance behind the fiscal plans and that we should not expect the backdrop of fiscal policy to be as favourable as set out in the March Budget.

**Foreign direct investment
matters**

Jamie Dannhauser raised the issue for debate of the significance of the extremely weak external position revealed in the fourth quarter. He expressed the view that the current account deficit had worsened for reasons other than a loss of competitiveness. The UK's investments abroad continued to attract lower yields than foreign investments in the UK, leading to a declining net investment balance as the main explanation for the worsening of the current account. Jamie believed that Sterling was still relatively cheap on a real effective exchange rate basis. Andrew Lilico raised the thought that China's recovery might imply a redirection of foreign direct investment.

The Chairman invited the members of the Shadow Monetary Policy Committee to summarise their views and offer their votes.

Votes

Vote by Philip Booth (in absentia)

(Cass Business School)

Vote: Raise Bank Rate by 0.5%.

Bias: Neutral.

Vote by Jamie Dannhauser

(Ruffer LLP)

Vote: Raise Bank Rate by 0.25%

Bias: to Raise

Jamie Dannhauser commented that Brexit or the possibility of Brexit was not a reason to delay an interest rate rise. It was better to commence rate rises early rather than late and the case for an immediate hike was well made from the tightening labour market and other indicators previously discussed. He mentioned Janet Yellen's preference for running the economy a little hot. Arguably, policy makers in the UK have adopted the same approach, but it was no longer justified for policy to remain on hold. His vote was for a quarter point rise in Bank Rate immediately with a bias to rise.

Vote by John Greenwood

(Invesco)

Vote: Hold Bank Rate.

Bias: Neutral.

John had a less bullish view of the UK economy. Referring to one of Jamie's presentation charts, he noted that inter-bank borrowing and lending has collapsed and that banks are fully matching their loan books with respect to deposits. He saw scope for bank regulation to become more lenient. With respect to the experiment with negative interest rates in the Eurozone, John was concerned that this was a policy error and unlikely to have a favourable outcome. He referred to the adoption of negative interest rates by Sweden, Denmark, Switzerland and Japan and the near deflationary conditions which still applied in those countries.

He turned to the mistaken application of quantitative easing in the Euro area whereby the central bank is making its purchases of government bonds from banks rather than non-banks. His concern was that bank leverage will increase when the authorities want it to fall.

John also observed that the UK consumer appeared to be losing momentum and that it would be a risk to begin a tightening cycle against this backdrop. Banks remain under the cosh from regulators and the lack of pass-through of credit conditions to end borrowers suggested to him that the economy is not in imminent danger of overheating. His vote was to for no change in bank rate and neutral bias.

Vote by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by 0.25%.

Bias: Neutral.

Andrew was concerned that the downward move in the interest rate curve would drive irresponsible borrowing and would exacerbate the distortions in the economy. He believed that the downward lurch in Sterling since the start of the year bakes in an interest rate rise. He thought that in view of the potential exit from the UK from the European Union, that it was better to begin a tightening cycle in advance of the June referendum and that the committee should not be deterred from raising rates now.

He feared that it might be harder to raise interest rates after a successful Brexit vote. Andrew agreed that the pace of broad monetary growth was not bad by recent standards and agreed with previous committee members that it was time for a regulatory truce. Andrew observed that an explanation of the very strong labour market participation might be the numbers of people needing to service quite high debts in proportion to their income and that this might also be deterring them from changing jobs. He wondered whether pay acceleration would occur if interest rates were to rise. People would need higher incomes to cope with interest rate rises. Nevertheless, his vote was for a quarter point interest rate rise and his bias is neutral.

Vote by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by 0.25%.

Bias: to Raise.

Patrick's preference is for Bank Rate to rise by a quarter per cent immediately and for the £375bn of quantitative easing to be gradually reduced. His bias was for Bank Rate to rise further.

Vote by David B Smith

(Beacon Economic Forecasting)

Vote: Raise Bank Rate by 0.25%.

Bias: Neutral.

David returned to the failure of prior fiscal retrenchment, considering it to be too fearful and unambitious. The increase in tax yield that had been hoped for had not been achieved. The UK's government spending ratio remains high in an OECD context. He noted that the UK workforce was increasingly determined to engage in work, indicating elastic labour supply conditions, particularly in regard to occupations served by migrant workers, leading to less wage inflation. Referring to the growth of M4ex measure of the money supply, running approximately at 4½% annual pace, he believed that this was adequate and still accelerating.

Based upon a combination of the behaviour of the real exchange rate and interest rates, he viewed the current policy setting as too loose. His vote is for a quarter point increase in rates, but with a neutral bias. David went on to mention the sensitivity of house prices to real interest rates, which is even greater than that of the exchange rate and much greater than household consumption. His concern about the low level of real interest rates was that these were stimulating consumption rather than investment.

Furthermore, there were significant differences in the size of the private sector contribution to the regional economies. These were structural imbalances that could not be addressed by monetary policy.

On a personal note, David announced that this coming meeting in July would be his last attendance at SMPC; he wished to step down in view of reaching his 70th birthday in June.

Vote by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by 0.25%.

Bias: to Raise.

Akos Valentinyi agreed that Brexit shouldn't guide rate policy. He concurred that monetary developments were healthy overall and that the case for normalising policy settings was persuasive. His vote was to increase Bank Rate by a quarter point and with a bias to tighten further.

Vote by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by 0.25%.

Bias: to Raise.

Peter reflected that he had voted consistently for an interest rate rise for more than 3 years and that numerous opportunities to commence the tightening cycle had been missed. He was concerned that the MPC was institutionalising low interest rates and lacked the courage to begin tightening, despite a mountain of supportive evidence.

Obstacles to a forthcoming rate rise were likely to increase in the near term as the gloss peels away from the UK consumer outlook. Fiscal tightening had been abandoned prior to the 2015 general election but had returned with a vengeance. The Treasury and OBR have overestimated the ability of households to absorb fiscal tightening.

In continuing to press for a Bank Rate increase, Peter conceded that the UK economy was faltering and that this may not be primarily attributable to the deferral of spending decisions ahead of the EU referendum,

Vote by Trevor Williams

(University of Derby)

Vote: Hold Bank Rate.

Bias: Neutral.

Trevor Williams agreed that structural issues can't be rectified by monetary policy, that the supply side needs to become more flexible allowing for expansion to occur without accompanying inflation. He thought it was important not to have a knee jerk reaction to the strong increase in labour demand and to give growth a chance.

He observed the weakness of labour cost inflation and believed that the pace of monetary growth was still too slow to be consistent with the inflation objective. He thought that broad money growth should be in the range of 6-8% per annum for this to be consistent with the 2% inflation objective.

Trevor also drew attention to the increasing deficit of the household sector, viewing this as a concern for the future pace of consumer spending. Trevor noted the fall in the household saving rate to a post-financial crisis low and believed that this was a concern for the economy in the medium term. Such imbalances would not be solved by an interest rate hike and hence his vote was to hold interest rates with a bias to neutral. Trevor believed that new technologies were driving capacity growth in a way that was not being properly captured by the data and this capacity extension posed deflationary risks.

The discussion concluded. The Chairman noted that there were only eight voting members present and that the ninth vote would be sought from one of the remaining members not in attendance. Such a vote was subsequently obtained from Philip Booth.

Policy response

1. On a vote of seven to two, the Committee voted to raise Bank Rate.
2. Six members voted for an increase of 0.25% and one of 0.5%.

Date of next meeting

Tuesday, 12th July 2016



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