Shadow Monetary Policy Committee votes unanimously to Hold Bank Rate in January.

Minutes of the meeting of 15th January 2019

Attendance: Phillip Booth, Juan Castaneda, Julian Jessop, Andrew Lilico (Chairman), Kent Matthews (Secretary), Trevor Williams.

Apologies: Graeme Leach, Patrick Minford, Peter Warburton

Chairman's comments: Andrew Lilico said that Julian Jessop who is no longer the IEA representative will present the global and domestic background as an independent member of the SMPC. He officially declared the meeting open.

The Global Economy Backdrop

The focus on Brexit has meant less notice that the global economy is slowing.

Julian Jessop referred to his presentation slides. He said he will begin with the global backdrop, then move on to the recent performance of the UK economy, before concluding with a discussion of Brexit risks.

He said that with the focus on Brexit, something that is not often mentioned is that the global economy is slowing. Two indicators are the JP Morgan global PMI output index, and advanced economies and emerging economy GDP growth forecasts. The global PMI is coming off the boil but is clearly still better than 2015-16. Advanced economy GDP growth is expected to slow and growth of emerging economies is expected to cool down. But headline figures are not as informative as the breakdown of the sector movements.

Several sectors stand out as a concern. Potential leading indicators are metals & mining output, basic materials, chemicals, and forestry and paper products. Other weak sectors at the end of 2018 included automobiles and real estate. In both cases, Europe was the main source of weakness. The automobile sector is reacting not just to the issue of diesel but also to the slowdown in China. There has been considerable excess production in the auto sector. Services seem to be holding up relatively well, with the weakness largely in manufacturing.

Fading US policy stimulus, China slowdown, automobile sector weakness.

Reasons for the global slowdown include nervousness in financial markets but this is really a symptom of the underlying economic factors. He said that the key drivers included fading policy stimulus in the US, credit slowdown in China, problems in the auto sector, poltical uncertainty, and high levels of debt.

Trevor Williams said that problems in continental Europe are also key to the weakness being seen in global output, to which Julian Jessop said that the problems in the auto sector figure for Germany, political uncertainty for France, and high debt for Italy. Andrew Lilico said that problems for the auto sector also figure for France. Juan Castaneda said the problems in the banking sector also matter in the case of Italy. Andrew Lilico asked for clarification if the slowdown in the US was also a tightening of monetary policy. Julian Jessop said that this was part of his narrative of a slowdown in policy stimulus, both fiscal and monetary. Trevor Williams said that the shape of the yield curve in the US was signalling a slowdown to below-trend growth there.

There was a discussion about the drivers of the auto sector slowdown and in particular fundamental factors such as low-cost production in Eastern Europe, technological shocks, Brexit, and the downturn in demand from China. However,

Julian Jessop said that the common theme of the indicators is that the global economic recovery is relatively advanced and probably due a slowdown.

UK economy

German car market particularly impacted by Brexit…

On the UK, Julian Jessop said that the latest figures show UK industrial production slowing but if the UK is in the slow lane, other countries have pulled off the road completely. He referred to charts showing large falls in industrial production in Germany, Italy, Spain, and France in November. Preliminary GDP figures for 2018 suggest that Germany only narrowly avoided a technical recession in the second half. He said that one-in-three newly registered vehicles in the UK is a German export, and one-in-five new cars exported from Germany is to the UK. Therefore, Germany is particularly impacted by Brexit as regards the car market in the UK.

…UK growing moderately.

He said that the UK is growing moderately, but there still no sign of the predicted post-referendum 'recession'. Andrew Lilico asked whether the Q1 figures which always show weakness means that the seasonal adjustment is faulty. There was a short discussion about seasonal adjustment and ONS practice. Julian Jessop said that he was wary about monthly figures for GDP produced by the ONS but the latest monthly data show that even with zero growth in December, we were on course for 0.3% quarter-on-quarter in Q4 2018. UK growth has probably benefitted a little from precautionary stock-building ahead of Brexit, but this at least also means that the economy is already prepared for some disruption in the event of 'no deal'.

Brexit deal or no deal?

Julian Jessop said that he could not avoid commenting on the Brexit vote expected later in the day. He said that this is what we know. When, not if, the meaningful vote is lost, HMG has three parliamentary days to come back to parliament with an alternative plan of action. If they do win, which they won't, it will only be because of some game-chaging amendments to the deal which means returning to the EU anyway. The positive thing is that there may be some amendments that are approved while the whole deal is voted down. The amendments may prove to be the basis for an amended deal which will be the basis of new talks with the EU.

Labour will call a confidence vote, which he said he was confident that the government will win. If HMG loses, Corbyn will be asked to form a government in 2 weeks. The default is that the UK leaves without a deal, unless the government stops or delays Brexit. He said that his understanding is that unless something changes, the UK is leaving on 29th March. There is no time for a 'Peoples Vote'. If the government asked for an extension of Article 50, he said that he was fairly confident that it would be granted, or the UK can unilaterally withdraw Article 50.

UK in the EU could cause instability.

Philip Booth said that if the UK remains in the EU against the will of the people it will become a disruptuve force within the Union and could cause considerable instability. Andrew Lilico said that he believed that there will not be a no deal outcome but he said that he would like to hear what Julian Jessop felt would be the results of a no deal Brexit.

No deal, damaging and messy but not disastrous.

Julian Jessop said that a no deal outcome is potentially damaging and messy but need not be disastrous. He said that after leaving, a better deal can be negotiated and that would be a stronger position to be in to start negotiations than the position we are in now. He said that he could not say for sure what the effect on GDP would be from a no-deal outcome. People have looked at various historical events, such as the 'winter of discontent' for estimates. If the UK did not leave, the political uncertainty would drag on and there is an argument that the economy should take the hit now and then negotiate from outside the EU.

Julian Jessop referred to the Bank of England Agents' survey that showed two-third of companies have already changed their business since the EU referendum,

or don't expect to, which suggests that the corporate sector is more advanced in its preparations than the government in being ready.

Trevor Williams asked if this included the financial services sector. Julian Jessop said that this covered all sectors but his contacts in the City say that financial firms have made preparations wihout yet moving many jobs. The labour market in general is continuing to tighten with real wages and unit labour costs rising. Sterling has weakened and is looking cheaper.

In conclusion, the global economy is slowing, but not collapsing. Real wages in the UK are recovering and investment may snap back when Brexit uncertainty eases. Julian Jessop said that he believed that the UK will return to the top of the growth league tables in 2019 and beyond. He said if not for Brexit dominating the economic scene, we would be talking about looser fiscal policy, highlighting the case for a further tightening of monetary policy.

Comment

Article 50 delayed?

Andrew Lilico said that in his opinion Article 50 will be extended and a deal will be hammered out which results in a political realignment which he defined as a break-up of the Conservative party. He said that historical precedents that provide a handle on the negative effects of a no-deal would be the three-day week, or the 1979-80 industrial unrest. Philip Booth said that those analogies would not be appropriate as they are domestic shocks to productive capacity. He said that a better analogy would be the effect on the New Zealand economy from the UK joining the EU. Julian Jessop said that he had not tried to quantify the effects but he thought that it could be 'nasty, brutish, but also short'.

Immediate output loss from no deal

Andrew Lilico asked what would be the likely result in the quarter following the initial drop in output? Julian Jessop said it depended largely on the policy response. Importantly, the EU would not have any leverage left as the UK would have exited the union and could start a serious negotiation on a good deal. Andrew Lilico said that the OECD had conducted a no-deal simulation where a trade deal would be negotiated in 2023. He said this entailed a loss of 3% in 2021 and a further loss of 1% the year after. He said that we need to have some understanding what is likely to happen to the economy to come out with a policy recommendation.

Equilibrium real rate of interest

Andrew Lilico asked under what situations would interest rates be raised even with Brexit uncertainty? Would a Brexit shock be a temporary supply shock or permanent one? He said it was unclear in Julian Jessop's commentary as to why rates should not be raised. He said that the real rate of interest is below some natural rate and that has negative implications both for productivity and for long-term growth.

Philip Booth said that interest rates have remained low for a decade with no evidence of inflation rising. He said that as a result of demographics and other reasons, perhaps the natural rate of interest has fallen closer to the actual rate.

Andrew Lilico said that a new equilibrium could be low growth, low inflation, and a low real rate of interest. Kent Matthews said that even with zero inflation the current real rate of interest is low and being lower than long-term growth is not an equilibrium. Either economic growth will be lower long tem, or the real rate of interest will rise.

Andrew Lilico invited those present to make their votes.

Votes are recorded in order they were given

Comment by Phillip Booth

(St Mary's University)

Vote: Hold
Bias: No bias. Bias to resume QE.

Phillip Booth said that there was too much micro management in monetary policy in general. Therefore, to take a decision on interest rates when there is a great deal of uncertainty is not a good thing. Unless there is an obvious signal to raise rates, and he said that he saw no obvious signal, rates should stay on hold. He said that he had no bias but to observe broad money and decide on the data as it emerges. If broad money remained flat then the bias is to resume QE.

Comment by Juan Castaneda

(Institute of International Monetary Research and University of Buckingham)

Vote: Hold
Bias: No bias but consider resuming QE.

Juan Castaneda said that he had not seen anything in the presentation about inflation expectations. Furthermore, UK broad money growth continues its deceleration over the past year, M4x from 2.6% to 2.2% annual rate of growth in November 2018. If broad money continues to decelerate he said that he would consider resuming QE. For this reason, he expressed caution with no bias and to hold interest rates.

Comment by Julian Jessop

(Independent Economist)

Vote: Hold.
Bias: Bias to tighten.

Julian Jessop said that when Brexit uncertainty eases the case for raising interest rates is strong. But raising rates in the current climate would unnecessarily add to uncertainty. For the sake of waiting a few months he said that he would hold rates. He said that he would pay less attention to the monetary aggregates and more to what he sees happening to the real economy. He said that uncertainty has the dominant weight in his reasoning and represents an exception to the general rule, but he said that he would be happy to raise rates aggressively once the Brexit uncertainty has eased.

Comment by Trevor Williams

(University of Derby & TW consultancy)

Vote: Hold.
Bias: No bias.

Trevor Williams said that there were short term reasons to hold rates as well as long term reasons, such as slowing productivity and adverse demographics. He said that Julian Jessop had covered the short-term issues and the state of the UK economy, but we should not ignore some of the long-term trends. He said that he would not envisage a cut in rates as that would add to even more uncertainty. Interest rates have remained extraordinarily low for over a decade with no inflation problem, despite a weaker currency.

The shape of the yield curve means that low inflation is embedded in rates, and in a lower growth trend as evidenced by the productivity figures. He said that all

sectors were borrowing which is financed by money coming into the UK. It is therefore incumbent on the government to maintain a deregulated environment, that makes the UK attractive for foreign capital. He said that QE has damaging side effects on the economy regarding inequalities in asset price movements and should not be deployed.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: To Hold.
Bias: bias to raise but also be prepared to resume QE.

Kent Matthews said that uncertainty was unprecedented and that was enough reason to leave interest rates on hold in the short-term. He said that he did not accept the arguments that short-term rates be kept low long term. The low productivity figures are not an equilibrium outcome consistent with a low growth, low inflation world, but a disequilibrium caused by financial repression that has created a low growth, low productivity situation.

The economy needs to get back to an equilibrium where funds can flow away from low-productive sectors to emerging high productive sectors. These are microeconomic arguments that can be taken up again once Brexit uncertainty has cleared. He said that he was in favour of putting the resumption of QE on standby not because of the broad money figures, which he saw as endogenous to the cycle, but to the potential of a financial market collapse in the EU that would cascade into UK financial markets.

Comment by Andrew Lilico

(Europe Economics)

Vote: To Hold.
Bias: To Raise and reverse QE.

Andrew Lilico said that he was content to hold with a bias to raise and a bias to reverse QE. He said that a short period of 'masterful inaction' is required in these circumstances.

Comment by Graeme Leach (in absentia)

(Macronomics)

Vote: To Hold
Bias: No bias.

The primary concern is the growth of broad money at only 2.2% year-on-year.

Comment by Peter Warburton (in absentia)

(Economic Perspectives Ltd)

Vote: Raise Bank Rate ¼%
Bias: To raise Bank Rate in steps of ¼% to 1½% and announce the phased reversal of QE.

The tightness of the labour market should have emboldened the Bank of England's MPC to crack on with interest rate rises long ago. It is irresponsible to assume that Brexit-related traumas will take the sting out of UK inflation in 2019. On the contrary, an acceleration of unit labour costs and the rebound in crude oil prices

should set a firmer tone to UK CPI inflation in the coming months. The prospect of another episode of temporary Sterling weakness and the possibility of acute supply chain disruption, especially in food, add to the inflation risk profile this year.

In contrast to the ill-considered August 2016 Bank of England playbook, the bias in the period beyond end-March 2019 should be to higher interest rates across the yield curve. UK monetary trends remain subdued, but not unduly worrying. The Bank of England Monetary Policy should be emboldened by the resilience of the real economy this year to press on with measured rate hikes. The next 3 quarter points should be executed mechanistically to return Bank Rate to 1.5 per cent. An announcement of the phased reversal of the QE programme, initially to withdraw the £60bn added in 2016, should be implemented as soon as possible.

Comment by Patrick Minford (in absentia)

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate ¼%
Bias: To raise gradually and reverse QE

Policy response

1. Those who attended voted unanimously (6 to 0) to keep rates on hold.

2. Three other votes in absentia had two members voting for a ¼% rise and one for a hold.

3. On a vote of 7 to 2 the committee therefore voted to keep interest rates on hold.

4. Brexit concerns was the main reason given for the recommendation to hold rates.

5. There was no consensus as to bias in future policy. Some members retained the bias to raise rates once the Brexit process is clear. Others said that QE should be held in reserve for resumption. Others had no bias.

Date of next meeting

16th April 2019.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists whose purpose is to monitor the decisions of the Bank of England's official Monetary Policy Committee and make policy recommendations of its own.

The SMPC has met once a quarter since July 1997 at the Institute of Economic Affairs (IEA). In those months where there is not a physical gathering, the SMPC conducts an email poll.

SMPC membership

Joint Chairmen:

Dr Andrew Lilico (Europe Economics)
Professor Trevor Williams (Derby University, TW Consultancy)

Secretary:
Professor Kent Matthews (Cardiff Business School)

Other current members:
Professor Philip Booth (IEA Senior Academic Fellow and St Mary's University)
Roger Bootle (Capital Economics)
Dr Juan Castañeda (Institute of International Monetary Research and University of Buckingham)
Professor Tim Congdon (Institute of International Monetary Research and University of Buckingham)
Jamie Dannhauser (Ruffers LLP)
Anthony Evans (ESCP Europe Business School)
John Greenwood (AMVESCAP)
Julian Jessop (IEA Economics Fellow)
Graeme Leach (Macronomics)
Professor Patrick Minford (Cardiff Business School, Cardiff University)
David B Smith (Beacon Economic Forecasting)
Professor Akos Valentinyi (Cardiff Business School, Cardiff University)
Dr Peter Warburton (Economic Perspectives Ltd)
Michael Wickens (University of York and Cardiff Business School)