
IEA Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes six / three to raise Bank Rate in February.

At its most recent face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of six to three, to raise rates in February.

It was widely agreed that there is no discernible negative impact from the Brexit vote on the UK economy so far, and that the August interest rate cut was an error. The advocating a rise note that GDP growth is solid, unemployment is low, monetary growth is rapid, sterling is weak and inflation is set to go above target. What reason could the Bank of England have for allowing inflation to overshoot the target when it is so straightforwardly within its power to prevent that? Two members felt that the need for pre-emptive action implied an immediate 0.5% rise. Others felt that a steadier 0.25% would do to begin with, though a number favoured further 0.25% increments at other meetings through 2017.

Those favouring a hold offered a range of arguments in favour of their view. Some were concerned that a rise at this stage might reverse what they regard as a wholly benign and overdue depreciation in sterling. Others felt that the economy has been mired for so long that it is worth “running it hot” for a period to see whether that boosts a rise in the underlying potential output growth rate.

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 ‘spares’ 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 SMPC poll will be released on the Sunday of 30th April 2017.

Minutes of the meeting of 10th January 2016

Attendance: Roger Bootle, Jamie Dannhauser, Andrew Lillico (Chairman), Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams.

Chairman's comments:

The Chairman said that he had no announcements to make and invited Jamie Dannhauser to present the global and UK monetary situation.

Economic and Market Update

Strongly improved global economy...

Jamie Dannhauser posed a number of questions and over-arching thoughts to structure the discussion. The principal question was whether the global wobble had become a reflationary trend and if this was sustainable? Along with this he posed the question whether the 'secular stagnation' risk had been overplayed? His view was that the global picture has improved considerably. He showed the committee a Fulcrum now-cast chart produced by Gavyn Davies that showed a noticeable acceleration. The Goldman Sachs leading indicator shows that Q1 2017 looks to be better than Q4 2016. The Leading and Coincident indicators are China related. The indicators show that China has bounced back strongly with 12 months of above trend growth. The US is close to capacity and is at a point where a response from the FOMC is expected. The indicators also show the Eurozone is growing at its best. So both developed and emerging economies are growing well. As a comment, he said that the growth in China is still strongly credit fuelled and poses problems for the medium term, but not the cyclical short term. In summary, the global backdrop is the best for UK exports as a small open economy.

US economy is close to the point where a response from the FOMC can be expected

Andrew Lillico asked if there are any contributions or questions of clarifications that members wanted to make at this stage. Patrick Minford asked if the global upturn is associated with the global growth in credit. Jamie Dannhauser said that except for China he was not sure if that could be said for all of the economies. Trevor Williams said that the UK has seen a pick-up in credit growth. Peter Warburton said that his reading was that credit was decelerating in China, India, Brazil and Russia, and a strengthening of credit growth in the advanced economies. Andrew Lillico suggested that we come to the discussion of credit trends later.

Official circles... too much emphasis placed on the effects of uncertainty on demand

Turning to the UK, Jamie Dannhauser referred to what the data was showing on the economy. Two questions that structured the discussion was how fast the UK economy is growing? And will Brexit-related damage emerge? The big picture is the UK economy is doing well. There had been too much emphasis on the effects of uncertainty on demand. It is clear that output growth has been robust since the Brexit vote with the lead being taken by the private sector. Since April the internationally exposed part of Business Services have been doing very well. Retail sales growth registered the best quarter since 2001. There is no evidence of a slowing down in Q4 or in the current quarter or the rest of the year. This is also what comes from the Business surveys which show an 18-month high. Forward looking indicators do not support the view that uncertainty is affecting capex spending and demand all that much. This view is also confirmed by hiring intentions and the strong demand for labour that is also reducing inactive labour. The indicators point to a 'hot' labour market.

Household balance sheets different from 5 years ago....

What is also different is the balance sheets of households. The share of households with outstanding debts has declined rapidly post-crisis. Indeed, the proportion of UK households with an outstanding mortgage has dropped to a 35-year low. Moreover, a record low share of mortgagors find themselves in financial difficulty. Of note also is the improved distribution of debts within the personal sector: despite the significant decline in real interest rates over the last decade, the share of highly-indebted households is back to its 2004 level. Overall, the balance sheet position of households is now quite different from what they faced 5 years ago, the last time they faced a “price level” shock.

Turning to the monetary and financial conditions, the market does not anticipate any hike in the rate of interest for another 2 years, which is unrealistic. On a 50-year trend, sterling looks about 10-15 per cent lower than its long-run, based on a real effective exchange rate basis.

Turning to interest rates, Bank of England data shows that post-Brexit bank internal funding costs and mortgage spreads have declined. Money growth has been solid although weakened a little recently, but at 5%-6% it is what we would expect at this stage of the cycle. Looking at a chart of net gilt purchases by sector, he said that what is striking is the extent to which QE is currently boosting broad money, more than one-for-one, which is contrary to what has happened in the past (on the basis of Bank of England research work). That research had shown that due to various leakages, the pass-through of QE had been less than one-for-one.

Discussion

Brexit factor is not there... The Bank needs to head off a consumer boom

Patrick Minford said that he agreed with Jamie Dannhauser’s analysis and that the UK economy was in the middle of a strong consumer boom coincident with the uptick in the world economy. He said that policy-makers are misinterpreting what is going on, particularly blaming everything on Brexit. This psychology of saying something terrible is going to happen because of Brexit is overlaying their responsibility as policy-makers to see what is going on under their noses. He said that the Brexit factor is not there. The policy-makers are justifying themselves by saying that it is not there now, but is just delayed. The Bank needs to be heading off the consumer boom that is building up by raising rates urgently and getting away from its QE programme. In the labour market, a good indicator of tightening is the increase in strikes which would not have happened 2-3 years ago. The British establishment has done this before. They get obsessed with a problem which colours their analysis. With the Heath-Barber boom they were obsessed with unemployment. In the 80s we had the shadowing of the DM which led to a consumer boom. Basically these obsessions lead them to take their eye-off-the-ball. The current obsession is Brexit.

Signal extraction and consumer behaviour...

Andrew Lilico asked whether under a rational expectations framework we can infer that the positive response of consumers is because they do not see a worsening of the economy. Patrick Minford said that is exactly what is happening. He said that any one knows that free trade is good. What is happening is that policy-makers do not believe that we do free trade. They assume that we will maintain a protectionist policy. Consumers are sensitive to expectations and if they believed that something awful was going to happen to the economy they would not behave in a positive way.

Oil prices and consumer behaviour...

Roger Bootle said that Brexit cannot be used to explain the behaviour of consumers all over the world and he said that it is to do with oil prices. The markets were convinced that falling prices were bad for oil producers but it is clear that it is good for consumers and although they have risen a little, they are still well down from their heights and consumers have responded positively.

Jamie Dannhauser continued with his presentation and said that consumers are well aware of the inflationary pressures as shown by the evidence of the inflation expectations survey. 'Core' inflation is heading back towards the comfortable window of 1.5%-2.5%. Recruitment problems are showing up in expected pay growth and inflation is rising, which is not just being driven by rising import costs. The indications are that inflation will be at 2% by the middle of 2017. He said that he finds no evidence for the Bank's view that lower retail margins will limit the pass-through of inflationary pressure and that inflation will be higher than 2% by the middle of 2017.

Economy at full employment....running the economy hot...

In summary the economy is effectively at full employment and if you run the economy hot there will be an inflationary response. The global backdrop is critical. Clearly there are risks to the global economy but the growth momentum is considerable. Inflation will rise sharply in 2017 and given the policy position the danger is to medium-term inflation.

Andrew Lilico asked to what extent the analysis by Jamie Dannhauser would alter if sterling were to recover 5% - 6%. Even a modest rise in the interest rate could have strong effects on the exchange rate? A lot of investors are expecting a further drop when Article 50 is triggered.

Jamie Dannhauser said that there had been a supply shock that required a depreciation of the exchange rate but exactly how much is anyone's guess. Extracting cause and effect is hard to figure out.

Kent Matthews said that Patrick's model forecast was based on a supply shock that results in a real exchange rate depreciation to restore equilibrium. In a world of low inflation, this real shock is translated into a depreciation of the nominal exchange rate. Since the expectation is for a 5-6% real exchange rate depreciation, the depreciation of the nominal exchange rate by 10-11% could be interpreted as an over-reaction.

Andrew Lilico said that the exchange rate therefore could reverse. He also asked if there is anything that can be inferred from Q4 broad money growth.

Financial crisis and 10 year impact...

Roger Bootle said that the financial crisis had not been mentioned in the discussion. Rogoff and Reinhart had written about a 10-year impact and basically the economy is recovering from the long drawn out effect of the financial crisis. There are still dangers from the Eurozone, where the banks are still weak. He said that we cannot be completely confident that we are out of the woods yet.

Trevor Williams said that one of the reasons we need a lower exchange rate is because of productivity differentials between the UK and her trading partners. Comparing the US with the UK, the participation rate is higher in the UK because of lower relative productivity but the UK and USA have similar unemployment rates.

Productivity shock and the real exchange rate...

Kent Matthews said that there is a problem of causation in this explanation as it can equally be argued that a positive productivity shock will reduce expected unit labour costs and improve expected competitiveness. In a rational expectations framework, the expected improvement in competitiveness is translated into a decline in the real exchange rate and a depreciation of the spot rate.

Andrew Lilico asked what the consensus among the committee was about inferring the behaviour of consumers to Brexit in a rational expectations context. If the expectation is that Brexit will not result in a negative shock to growth, household's consumption behaviour will be dictated by underlying fundamentals.

Kent Matthews said that we did not need to go to rational expectations to explain this behaviour as it fits in with an earlier vintage of consumer behaviour known as the Permanent Income Hypothesis.

Tightening of benefit regime affect household spending...

Peter Warburton said that the resumption of the tightening of benefits that were relaxed in the past year will resume in the coming year as part of a return to a tighter fiscal stance. So the inference is that consumer spending grew in 2016 with the help of a relaxation of the benefit regime, and a consumer slowdown will occur in 2017 as the benefit regime tightens.

Andrew Lilico said that that was an interesting point and is one interpretation about the lag in effect. He said that Andrew Haldane's comment that consumers had continued to behave as if Brexit had not happened can also be argued that they behave as it has happened. HMT has argued that the Brexit factor will lead to reduced output and in a forward expectations framework this will lead to a decline in current consumption. Perhaps the fault is in the assumptions underlying the forecast and not the model and not economic theory.

Jamie Dannhauser questioned the realism of the rational expectations framework and said that liquidity constraints meant that current income was what dictated consumer spending.

Votes

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate ¼% and reversal of QE.

Bias: to raise.

Patrick Minford said that we are in a serious situation of fermenting what is referred to as a bubble. Jamie's analysis shows that all the indicators are pointing in this direction. He said that interest rates **should be raised by 25 bps and QE should be reversed.**

Comment by Jamie Dannhauser

(Ruffer)

Vote: Raise Bank Rate ¼% and end current QE purchases.

Bias: to raise rates further.

Jamie Danhauser said that the programme of QE should be ended which means not renewing gilt purchases and **rates should be raised 25 bps**, with a bias to lifting Bank Rate a bit further. He reiterated his previous position that the August MPC decision to ease policy had been a mistake. The first step was restoring the pre-Brexit vote policy stance. However, given the current solid growth pace, the limited evidence of any material hit to business expansion plans and robust monetary indicators, he felt it reasonable to signal three things: firstly, that the next move in Bank Rate would be up; secondly, that the current policy setting was inappropriately loose; and thirdly, that a somewhat higher level and path for Bank Rate would not imply "tight" monetary policy but merely a limited withdrawal of exceptional monetary ease.

Comment by Roger Bootle

(Capital Economics Ltd)

Vote: Hold Bank Rate.

Bias: to raise Bank rate.

Let the economy run for a while before applying the breaks

Roger Bootle said that the world economy is strong but this is not to do with the benefits of Brexit and more to do with the fall in the price of oil. Although oil prices have moved up, they are still well down from their heights. The economy is getting over the financial crisis. Dangers from the Eurozone still exist. Political risks can still trigger a financial crisis. Anxiety about the triggering of Article 50 and the potential for a series of bad news that may cause a blip still exist. Exports will improve and consumer spending will increase and therefore it would be better to let the economy run for a little and see what happens. **He said that his bias was to raise in rates but he votes to hold rates for the moment.**

The political economy scene is to welcome a rise in inflation

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate ¼%.

Bias: To raise Bank Rate.

Peter Warburton said that on the broad global outlook he has a different view. The strong conjuncture is consistent with the buoyant credit and monetary conditions that prevailed 6-12 months ago. However, these have since deteriorated: real private sector debt growth has fallen, the global interest rate curve has shifted upwards and steepened and some credit spreads have widened, notably sovereign spreads in Europe. Global credit conditions are tightening, not only as a consequence of a second US Fed funds rate increase, but more importantly as market pricing and behaviour changes. We are heading into a weaker global real growth environment notwithstanding the stronger inflation dynamics. In political economy terms, the rise in inflation is welcomed, and is unlikely to provoke a countervailing interest rate rise. However, as the SMPC, we can take a different view. Real growth will be weaker in 2017 **but it is entirely appropriate that interest rates should be raised by 25 bps and to continue rising in steps of 25 bps over the next 6 months at every meeting of the MPC.**

Comment by Trevor Williams

(University of Derby)

Vote: Hold. End the QE Programme.

Bias: To raise rates.

Consumers are vulnerable with double digit growth in credit

Trevor Williams said that the global backdrop was better than last year with lower oil prices feeding into consumption via real income effects. At the same time, continued low interest rates and aggressive QE policy from the EU and Japan are boosting monetary creation and asset price inflation. But there are still many risks, including a protectionist US. He questioned whether European growth could maintain its current pace without it being driven by a highly stimulative monetary policy.

On the UK, if growth does not slow of its own accord in 2017, he would vote for a reversal of the MPCs August 2016 rate cut. A slowing should could from overstretched households raising saving rates, or a slowdown in the world economy in the second half of the year from a steeper yield curve, or the actual triggering of article 50. You can believe in the permanent income hypothesis and rational expectations, and still believe that there was a momentary suspension of any risks attached to Brexit: that the UK could 'have cake and eat it'. To think consumers do not get it wrong would be to ignore the historical fact of boom and bust: they do.

He said that the QE programme should be suspended, however. The Bank of England should, and could, have waited for more signs of economic distress before cutting rates last year. However, it has time to wait to see if a natural slowing in the pace of growth occurs before raising them.

Monetary data show that the UK banking sector has healed. Rates of growth of broad money are consistent with continued 2% growth in the economy.

Inflation is not a serious risk, though, in his view as the fall in the currency is a price level effect and is unlikely to get embedded in wage or inflation expectations. The UK economy is not growing that fast. Moreover, the pace of technology and automation is exerting downward pressure on global inflation, as is global spare capacity.

He said that **interest rates should not change until there is more evidence of an economy running hot.**

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

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

Bias: to raise in small steps. Halt QE.

Microeconomic and macroeconomic arguments coincide

Kent Matthews said his argument for a rise in rates in the past were largely microeconomic rather than macroeconomic. These microeconomic arguments relating to financial repression and the misallocation of financial resources, have dominated the macroeconomic arguments for keeping rates low. But Jamie Dannhauser's analysis shows that the macro arguments have come into perfect intersection with the microeconomic arguments. He said that before the cut in rates he had voted for a rise in rates by 25bp and he should therefore ask for a rise of 50 bps. However, he said that he would happily go with the consensus and **voted to raise rates in small steps starting with a $\frac{1}{4}\%$ rise.**

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank Rate by $\frac{1}{2}\%$.

Bias: to hold for two months, then start raising by $\frac{1}{4}\%$ increments to 1.5%.

UK growth in 2017 will be in excess of 2%

Andrew Lilico said that the economy looks like it is growing pretty strongly and unless something unusual happens, like a Eurozone crisis, or an excessive appreciation of the pound, growth in 2017 will be in excess of 2%. In a monetary sense 2016 should be marked as the end of the great recession. Broad money growth of 7% is the sort of growth that is at the top end of what is desirable. This sort of monetary growth, along with very low rates is an unfortunate combination. On the labour market, there is little scope for unemployment to fall further. Inflation looks like is going to rise well above target. Regarding the argument that inflation rising above target being due to the fall in pound, he said that the pound would not have fallen if interest rates were higher. He said that he would not go for the rise in small steps. There needs to be a clear signal that the rise is not simply a reversal of the mistaken August cut but, rather, the commencement of a period of normalisation. Therefore he said that the rate should be raised by 50 bps. However, after this initial rise there should be a pause for a couple of months before raising again, to allow the market to get used to believing rates can go up.

Comment by Graeme Leach (submitted in absence)

(Macronomics)

Vote: Hold Bank Rate.

Bias: to tighten and no change in QE.

Broad money growth close to requiring a tightening...

The UK economy ended 2016 with a mixed bag of data. The UK services sector PMI survey expanded strongly in December, and now stands well above the 20-year average. The UK manufacturing sector PMI also expanded strongly, reaching a 30-month high. Adding to the good news, the UK housing market finished the year robustly, with annual inflation of 6.5% on the Halifax, and 4.5% on the Nationwide measure. However, the story was not uniformly good. The GfK measure of consumer confidence on the UK economy remained weak, well into negative territory – although measures of individual consumer confidence were much stronger. Latest figures for M4x broad money supply growth added to the uncertainty. M4X growth had accelerated over the May to October period from 4.9% (yr-on-yr) to 7.8% (yr-on-yr), but eased slightly to 6.7% (yr-on-yr) in November. M4x growth is very close to requiring a tightening in monetary policy, but any further slippage in the growth rate back towards 6%, or below, might avoid an increase. The December figures will provide an important signal. M4X growth above 6.5% (yr-on-yr) would change my vote next month to a tightening, given the current trajectory for inflation in 2017 is above 2%. A weakening in M4X growth back below 6% would provide some reassurance that headline inflation is less of a problem and **doesn't require an immediate increase in interest rates.**

Comment by John Greenwood (submitted in absence)

(Invesco Asset Management)

Vote: Raise rates to 0.5%; suspend asset purchases, but hold in reserve.

Bias: None.

Since the referendum on June 23 the UK economy has far outperformed both the expectations of the majority of British economists and the forecasts of numerous official institutions.

The straightforward reason for the continued strong performance of consumer spending, services and manufacturing is that purchasing power has been building in the economy since the start of the April-June quarter. By then the banking system had largely met the regulatory requirements imposed by the Prudential Regulatory Authority which acts within the Bank of England as the supervisory authority for 1,700 banks, building societies, credit unions, insurers and major investment firms. In particular, banks had overcome their capital shortage and had reduced to negligible levels their dependence on interbank or wholesale funding.

Banks in a position to increase their loan books...

As a consequence they were able – after a long interval of eight years -- to start expanding their loans books, thus raising the rate of growth of M4x. By July the rate of growth of M4 lending (excluding intermediate OFCs) had reached 9.0% year-on-year, and M4x had reached 7.0% -- both dramatically greater than they had been a year or even six months earlier. Since July the rates of growth have slowed a little, but in November the growth rates were still 6.1% and 6.7% year-on-year respectively.

The growth in spending power has been reflected in improved consumer confidence and a greater willingness of businesses to invest and expand output (as reflected in the monthly CBI survey). Until domestic inflation picks up enough to erode personal incomes there is little reason to fear a significant weakening in the economy. Although headline CPI inflation increased from 1.2% to 1.6% in December, average weekly earnings (including bonuses) rose 2.8% in the year to November, leaving some margin of real income growth. Provided that monetary growth moderates during the months ahead there should be no great pass-through effect from weaker sterling to the CPI. However, if monetary growth continues too rapidly, then domestically generated inflation could be added to imported inflation.

It is for this reason that interest rates need to start being normalised by gradual increases that do not threaten either a credit squeeze or a sudden slowdown in the growth of M4x. To avoid having to slam on the monetary brakes later in 2017, **the Bank needs to act now to reverse some of the unnecessary stimulus applied in August.**

Policy response

1. On a vote of six to three the committee agreed to reverse the Base rate cut following Brexit and raise the rate by 25 bps.
2. Two members voted to raise Base rate by 50bps.
3. There was unanimous bias to raise rates in the near future.

Date of next meeting

To be arranged.

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 Rotating Chairman is Andrew Lilico (Europe Economics). Other members of the Committee include: Philip Booth (St Mary's University, Twickenham), Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Ruffers), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (University of Derby).



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