# IEA Shadow Monetary Policy Committee

## April 2017

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

At its April 2017 face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) voted by seven to two, to raise Bank rate in May. This is the biggest vote for a rise since rates were cut to their historic lows. Of the seven members favouring a raise, four preferred a rise of 1/4% and three a rise of ½%. Of the two members voting to hold, one had a bias to raise once the election on 8th June was out of the way.

All those members calling for a rate increase felt that the cut of ¼% made in August last year needed to be reversed. Even if economic conditions did not improve much from current levels, a rise was justified to give room for further cuts in future should they be required. Some felt that it was to ward off an increase in inflation expectations amongst households, and others that it was to bolster the credibility of the Bank of England as price inflation rose above the 2% target. It was notable that no one thought the UK economy would slow sharply this year, even with Brexit negotiations and a surprise general election being called by Prime Minister Theresa May. That said, it was also clear that no one thought the economy would grow by much above a 2% annual pace this year, or that price inflation was a serious concern.

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.

## Minutes of the meeting of 18 April 2017

**Attendance:** Andrew Lilico, John Greenwood, Peter Warburton and Trevor Williams (Chairman).

**Apologies:** Roger Bootle, Tim Congdon, Jamie Dannhauser, Anthony J Evans, Julian Jessop (IEA observer), Graeme Leach and Kent Matthews (Secretary).

## Chairman's comments

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

## International monetary background

**Leading indicators suggest global growth upswing to remain solid.**

Andrew Lilico presented the April IMF global growth projections as an illustration of the benign consensus outlook over the next 4 years. He noted that the IMF has upgraded its forecast for the UK economy to 2% for 2017 and 1.5% for 2018. The UK had the second-fastest growth rate in the G7 last year. The continuation of solid, but unimpressive economic growth was expected to keep unemployment rates steady in US, Japan and Germany, and to tilt the rate lower in France, where unemployment has remained stubbornly high since the Eurozone banking crisis.

In terms of the cyclical conjunction, the OECD leading indicators remain in a positive phase, suggesting that the uptick in global growth could persist a while longer. However, the recent deceleration of US bank lending and broad money supply aggregates has aroused concern in some quarters.

## UK monetary, economic and political background

**UK economic activity has been firm in the face of uncertainty.**

Andrew turned to the UK monetary background, beginning with the growth and unemployment outlook. On the latest re-telling of the UK growth story, the burst of growth in 2013-14 compares favourably to the best episodes in the past 20 years. Economic growth has mellowed in 2015-16, yet has been much more resilient in the face of the uncertainties before and after the EU referendum vote last June. Andrew offered as an exhibit the Bank of England fan chart of GDP projections based on market interest rate expectations. The central expectation is for growth to range between 1% and 2% over the next 2 years.

Andrew highlighted the gain in business confidence during the second half of last year and the firm PMI readings for services and manufacturing. Quarterly real GDP growth of 0.4% was expected in Q1. *(The data has since been published: 0.3%)*. Unemployment continues to drift lower and the latest published rate is 4.7%, the lowest since 1975.

**Financial markets take a benign view about the UK's economic prospects.**

Andrew noted the quickening pace of UK M4 and M4 lending (both excluding intermediate OFCs) in 2016 and the marginal slowing at the start of this year. M4 growth peaked at 7.7% in September, slipping to 6.4% in February 2017; M4 lending growth peaked at 6.8% in June 2016, fading to 4.6% in February.He expects UK inflation to hold steady in the range 2% to 3% over the next 2 years.

Financial markets continue to reflect a benign view of the UK outlook, with strong overseas demand for UK gilts supplementing the recent £50bn asset purchase programme from the Bank of England. 10-year gilt yields are 1.1%, much lower than in the US. The Sterling index has recovered a little ground since the October low.

As prime minister Theresa May had, effectively, called a general election earlier in the day (18 April), Andrew considered the implications of the move:

**The general election opens up opportunities for repositioning policy.**

First, it potentially allows for extra flexibility in the Brexit negotiations. For example, freedom of movement of EU citizens might continue until 2022 in a transitional arrangement.

Second, conditional on being returned to government with a larger parliamentary majority, it allows PM May to escape from the 2015 manifesto pledges (regarding tax rates), increasing the scope to reduce the budget deficit and this overcome the difficulties encountered in implementing the spring 2017 Budget measures.

Third, it creates the risk of new, ill-judged, election pledges.

Sterling spiked higher after the election announcement.

**UK is seeking transitional arrangements in the Brexit negotiations.**

Commenting on the progress of the Brexit process following the triggering of Article 50 on 29 March, Andrew noted the risk of an early breakdown of the negotiations over the EU27 insistence on a "divorce bill" as a pre-condition. The UK government is seeking a free trade agreement (FTA) and bridging arrangements to avoid a cliff-edge in 2019, especially for financial services.

Trade deals with the US, Australia and New Zealand have been agreed in principle.

In summary, Andrew concluded that the UK economic and financial outlook was stable with solid economic growth, above-target inflation and no tangible risk of financial crisis.

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

## Discussion

**Low oil prices may raise the equilibrium real rate of interest.**

Peter Warburton contested the benign outlook set out by Andrew on two counts. First, that the global growth outlook was threatened by a broad deceleration of global real private sector debt, which was particularly noticeable in the largest emerging nations. A global credit mini-cycle was maturing and a new debt default cycle beginning to unfold. Second, in a UK context, the pass-through into inflation from Sterling depreciation last year was far from complete. Its effects on real consumer incomes were likely to become painfully obvious in

the next few months and would exert a restraining impact on household expenditures. Depending on the labour market response, there is likelihood that higher inflation will become entrenched.

**External risk factors.**

John Greenwood was reasonably sanguine about the global growth improvement. He reckons that US president Trump inherited a strong economy with household and corporate balance sheets in good shape. However, he acknowledged some divergent pressures on the US economy, arguing that financial markets have over-extended and that Trump's budgetary aspiration were unattainable. He dismissed concerns over the weakening pace of bank lending, suggesting that bond issuance and other forms of credit have compensated.

Considering the Asian economies, he noted that China's growth rate has picked up, aided by stronger global goods demand and a favourable comparison with Q1 2016. Japan's economy was also recovering.

**World economy reached escape velocity.**

Andrew Lilico returned to the question of the prospective real income squeeze on UK consumers, arguing that there would be an offsetting boost to economic growth from net exports. While there has been an improvement in net trade in Q4 2016, this was attributable to high value erratics. He reckoned that export volumes would react strongly to improved competitiveness and that net trade would bolster real incomes.

**FPC to control credit growth by intervention.**

Trevor Williams drew attention to a likely improvement in world manufactured trade volumes in 2017-18. He expected the oil price to settle back towards the lower bound of its recent trading range as Saudi Arabia lost patience with its fellow-members of OPEC and raised crude oil production. The global economic outlook would be sustained, in part, by low and stable oil prices.

**Strong UK import growth.**

Andrew Lilico surveyed the UK capital-spending outlook, arguing that some transitional slowing was probable from mid-2018 to 2019, but that investment should sustain positive momentum in 2017. He expects there to be little or no impact on investment from raising Bank Rate.

Trevor Williams noted that, despite buoyant business climate responses in the latest CBI survey, there had been little improvement in investment spending. He alluded to the long tail of unproductive companies (zombie companies) as one contribution to the persistence of weak productivity growth.

**Regulations are creating distortions.**

Andrew Lilico discussed the significance of the falling trend of gilt yields for fixed investment. Increased regulatory pressures had funnelled capital flows into fixed interest securities. He surmised that multiple rounds of QE have weakened the UK productivity trend.

Peter Warburton suggested that either Sterling or gilts were mispriced. If inflationary outturns were larger than expected, then gilts were much too richly priced. If inflation were to peak in the coming months and fall back below 2%, then Sterling has been discounted too heavily. Trevor Williams noted that inflation expectations have risen more abruptly in the UK than US. Andrew Lilico commented that, should gilt yield spike higher, the MPC would respond by extending the reign of rock bottom Bank Rate.

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

## Votes

### Comment by John Greenwood

**(Invesco Asset Management)**
**Vote: Raise Bank Rate 1/4%.**
**Bias: Neutral.**

John reiterated his stance that monetary conditions were too loose in the UK. The economy was performing surprisingly well, with an offsetting improvement form the industrial sector in the wake of a weaker Sterling. He did not consider that inflation was a threat, that it would not breach 3% in the absence of a stronger global commodities market. Banks were creating credit at a measured pace, monetary growth was more than adequate and there was no case for additional stimulus. He argued that the 25 basis point Bank Rate cut last August should be reversed and that QE and term funding purchases should cease. His bias was neutral on Bank Rate.

### Comment by Andrew Lilico

**(Europe Economics)**
**Vote: Raise Bank Rate by 1⁄2%.**
**Bias: To increase rates further.**

Andrew argued that it was appropriate not only to reverse the August Bank Rate cut, made on the false pretext of a post-referendum vote slump, but to increase rates further to reflect the robustness of the economy and the ascent of inflation above the 2% objective. Andrew was sanguine about the near-term economic outlook, expecting net exports to compensate for any weakness of private consumption and investment. His vote was to raise Bank Rate by 50 basis points, with a bias to further rate increases. He argued against any further increase in the size of the QE programme.

### Comment by Peter Warburton

**(Economic Perspectives Ltd)**
**Vote: Raise Bank Rate ½%.**
**Bias: To raise Bank Rate in steps of ¼% to 1½%.**

Peter agreed that there was no justification for delaying the reversal of the August rate cut, but would be prepared to go further and raise Bank Rate by 0.5% given the rapidly changing nominal environment. He was sceptical that CPI inflation would be capped at 3% or even 3.5%, as the pass-through of imported costs was far from complete and the labour market was ripe for wage acceleration. Recently, the National Living Wage had been increased to £7.50 per hour and this would have ripple effects on the wage structure. The Bank of England's MPC had lost credibility when it failed to follow through on planned rate increases at the start of 2016 and needs urgently to remind markets that it has the will to raise rates. Peter voted for an immediate 0.5% Bank Rate increase, with suspension of QE and the Term Funding Scheme, with a bias to raise Bank Rate in 25 basis point steps to 1.5%.

## Comment by Trevor Williams

**(University of Derby & TWC)**
**Vote: Raise Bank Rate 1⁄4%.**
**Bias: Neutral.**

Trevor was concerned that even a 2% growth rate might be above the UK's sustainable long-run trend, placing upward pressure on inflation. However, this would be mitigated by moderating oil and commodity prices. He was concerned that rising CPI inflation would squeeze real wages, turning real wage growth negative again. On balance, Trevor thought it right to reverse the 25 basis point rate cut of last August, but with a neutral bias, bearing in mind the geopolitical and domestic risks. He voted to leave QE at its existing total of £435bn, while acknowledging that the strength of the gilt market suggest that this would not be a bad time to commence an unwinding of the position. He did not, however, think that the MPC would raise rates, especially with the General election underway and Brexit negotiations not yet in full swing.

## Comment by Tim Congdon *(submitted in absence)*

**(International Monetary Research Ltd.)**
**Vote: Hold.**
**Bias: No bias.**

The regulators are again demanding that big banks raise capital/asset ratios - and asset growth and the growth of deposit liabilities (i.e., money) is falling. The deflationary impact of the regulators' demands is obvious, and yet hardly anyone seems to understand.

## Comment by Jamie Dannhauser *(submitted in absence)*

**(Ruffer Capital)**
**Vote: Raise Bank Rate 1/4%.**
**Bias: Further increases.**
**One year view: Further gradual increases; begin discussions about the balance sheet.**

The pre-emptive easing of UK monetary policy in August 2016 was a mistake. This is not because the economy turned out to be stronger than the MPC's central forecast at the time; but instead because it reflected poor *ex-ante* judgement about the scale of any growth slowdown and the costs of any policy stimulus. A forecast and policy decision is not erroneous because it turned out to be wrong – economic projections are inherently uncertain; but because it was based on faulty assumptions and miscalculation of the side-effects of unnecessary policy changes.

MPC members have repeatedly argued that their policy shift last year helps explain the economy's *substantial* outperformance in recent quarters. This is nonsense – and they know it (or at least they should). The lag from monetary policy changes to shifts in financial conditions and then to nominal spending means the August easing package is unlikely to have had much effect on growth

until the end of 2016 at the earliest, yet the economy not only failed to slow after the June referendum vote but actually accelerated quite noticeably. Moreover, it happens to coincide with a *global* upturn in output growth, which is the most likely proximate driver of activity in a small, open economy such as the UK.

Whatever judgement one made about slack in the economy before the referendum, we have now had a burst of above-trend growth that has absorbed additional spare capacity. The unemployment rate has dropped to its lowest level since 1975. Broader measures of labour force utilisation (similar to the U6 measure in the US) suggest labour market slack has continued to decline. Indeed, some measures suggest we have already reached “full employment” and may be entering the “overheating phase” – output above its long-run sustainable level.

Official ONS data for Q1 suggests growth softened noticeably, compared with Q4 2016; but given less volatile survey evidence and the surprising strength of official data a quarter ago, we view this as idiosyncratic noise, not an emergent slowdown. For all the discussion of a “consumer-led downturn”, there is scant evidence that the economy overall has entered a phase of below-trend output growth. Globally sensitive industries and sectors appear to be recovering strongly (in part because of weaker Sterling), just as higher import costs are squeezing consumer real incomes. Given the surprising strength of growth in the Euro Area, this is hardly surprising.

As remarked in previous submissions, there is a strong case for allowing the UK economy “to run a little hot”, as we exit the shadow of the GFC. Financial crises can cause lasting supply-side damage. A prolonged burst of solid demand growth will help ameliorate the long-run hit to UK living standards. (Economies are *path-dependent*, at least to some degree, so higher aggregate demand will lift the trajectory of potential output.) Thus, there is no reason to normalise monetary policy quickly; or get overly worried about a period of CPI inflation a *little* above the 2% target.

But gradually raising Bank Rate from its current level does not represent a meaningful tightening of monetary policy, especially since the dramatic fall in Sterling since the referendum means the *effective* monetary policy stance is markedly easier than it was a few months ago. Given the pace of growth, the apparently limited slack and the likely profile for inflation (“core inflation” should hit 2½% over the next few months), there is a strong case for hiking Bank Rate this month – and going further as the year progresses. Although uncomfortable that the stock of QE is £60bn larger than before the June vote, risk management considerations suggest now is not the time to start shrinking the balance sheet. If, however, output growth maintains its current pace, inflation surprises positively and downward pressure on gilt yields continues, then the MPC should start discussing how the Bank’s stock of gilts could be used to tighten financial conditions further.

## Comment by Julian Jessop *(submitted in absence)*

**(IEA observer)**
**Vote: Hold.**
**Bias: To tighten.**

While there are many uncertainties ahead – not least the impact of Brexit – the bigger picture is that inflation is above target and the economy no longer needs emergency support. Indeed, the longer that interest rates are kept at artificially low levels, the larger the costs from the misallocation of resources and the greater the risks that rates have to rise much more aggressively further down the line. The only factor that makes me hesitate from calling for an immediate (quarter-point) hike in rates is the imminent UK election. While the outcome may seem obvious, policy-makers should respect the democratic process. But once the election is out of the way, the next government looks certain to row back further on austerity, strengthening the case for returning interest rates towards more sustainable levels.

## Comment by Kent Matthews *(submitted in absence)*

**(Cardiff Business School, Cardiff University)**
**Vote: Raise Bank Rate by ¼%. No QE.**
**Bias: To increase rates further.**

The microeconomic argument for a rise in the rate of interest relates to the misallocation of loanable funds that has interrupted the Schumpeterian process of 'creative destruction'. This was a strong enough argument before the Brexit depreciation of the exchange rate. However, the fall in sterling since June 2016 can be interpreted as the response to an anticipated reaction to a future economy that is freer and more open post-Brexit that requires an improvement in competitiveness and a depreciation of the real exchange rate. In a world of relatively low inflation the only way a depreciation of the real exchange rate can occur is through a depreciation of the nominal exchange rate. The macroeconomic arguments have come into line with the microeconomic ones. The economy is operating at or at least very close to capacity. Domestic demand has to be restrained to allow external demand to respond to the depreciation of the currency. Interest rates have to rise to bring the economy back into balance.

## Comment by Patrick Minford *(submitted in absence)*

**(Cardiff Business School, Cardiff University)**
**Vote: Increase Bank rate by ½%.**
**Bias: Raise further, discontinue QE and reverse gradually.**

Patrick restates his position that the economy is performing perfectly well and that interest rates should be increased. My advice on monetary policy remains that interest rates should be raised by 0.25% in the next meeting, with a bias to continue raising; and that QE be discontinued and reversed gradually, with the aim of eliminating the whole Bank holding over the next five years.

## Policy response

1. On a vote of seven to two the committee agreed to reverse the Base rate cut following Brexit and raise the rate by 25 bps.

2. Three members voted to raise Base rate by 50bps. Four voted to raise by ¼%.

3. There was unanimous bias to raise rates.

## Date of next poll

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 Trevor Williams (University of Derby). 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), Julian Jessop (IEA), Graeme Leach (Macronomics), Andrew Lilico (Europe Economics), 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).

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