Shadow Monetary Policy Committee

18th July 2017

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Shadow Monetary Policy Committee votes eight / one to raise Bank Rate in August.

At a quarterly face-to-face meeting in July, the Shadow Monetary Policy Committee (SMPC) voted by eight votes to one to raise Bank rate. This was the second consecutive vote by the Committee to raise rates by this margin.

In a lively and well-attended discussion, the case for a rate rise was made by the majority on three grounds: first, a need to reverse what was seen as a unnecessary cut last year; second, the monetary statistics supported a faster growing economy than current data suggested and so liquidity was plentiful; third, it was high time that the emergency level interest rate still prevailing started a journey to some form of normality. Those wanting an immediate rate rise were split three in favour of ½% and five in favour of ¼%. The one dissenter to hold rates had a bias to tighten but argued that 'political uncertainty' meant that this was not the right time.

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 regularly gathers 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.

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Minutes of the meeting of 18 July 2017

Attendance: Roger Bootle, Jamie Dannhauser, John Greenwood, Julian Jessop, Graham Leach, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams (Chairman).

Apologies: Tim Congdon, Akos Valentinyi

Chairman's comments: The Chairman Trevor Williams noted those who had said they could not attend the meeting and invited Peter Warburton to present the global and UK monetary situation.

Global and Domestic Monetary Situation

Peter Warburton said that his presentation would focus on trends in global money and credit and less about the real economy and then finish with an examination of trends in broad credit and money in the UK.

Global trend in broad money growth unchanged but…

On the international front trends in broad money growth has little changed tracking at 7-8% a year. In the advanced economies the trend has been stabilising but there has been a reversal of the trend in emerging markets. But on aggregate it is a remarkably stable picture of broad money growth. Turning to the other side of the balance sheet with debt growth and corporate sector bond issue, the picture is one of deceleration in private sector credit. The detail shows a deceleration in corporate debt growth, softening in the financial sector but also slowing in bank lending growth.

… deceleration in private sector credit in US and China.

Essentially, this slowing in credit was down to the US and China. UK, France and Other Asia are pushing in the opposite direction but the centre of gravity has moved towards deceleration. The perception is one of easy credit but this is not supported by the volume data. What is interesting is that alongside the deceleration in private credit growth is an acceleration in global nominal GDP growth. Arguably, this is a lagging reaction to global money growth but there is still some scope for higher global inflation. So some inflation or stagflation pattern is emerging.

The detail on global inflation shows a slightly rising picture on the GDP weighted measure but it remains muted on a population-weighted measure. There is also some evidence of wage inflation pressure in some countries and tighter labour markets pointing to upside inflation risks. Financial markets indicators are of a benign picture. A widening spread on 2-year and 10-year bond rates indicates a rising policy rate based on past correlations.

Precautionary balances build up by UK corporates in response to Brexit uncertainty…

Turning to the UK monetary situation, Peter Warburton said that he looked at the broad money and credit trends to pull out some interesting themes as to what the statistics are indicating about the real and financial economy. First, the UK credit and money trends are not as supportive of real growth as they appear. The acceleration in broad money and credit aggregates in the past two years have mostly benefited financial intermediaries and large private non-financial corporations holding cash and short-term assets on their balance sheets. Possibly reflecting multiple contingencies, the corporates are preparing for a Brexit situation as a precautionary measure.

Consumer access to unsecured credit tightening….

Finally, turning to the household sector, the picture is one of real income squeeze and tightening credit conditions. Mortgage borrowers are scrambling to procure cheap 5-year and 10-year fixed rate loans. This could weaken some of consumer spending next year, but the corporate sector has built up liquidity to absorb contingencies. He said he was not unduly concerned and wished to see the SMPC vote to continue the process of normalisation.

Discussion

Trevor Williams thanked Peter Warburton for his excellent presentation and invited the committee to make their comments.

Andrew Lilico questioned the connection between the rise in the liquidity ratio of corporates and the acceleration in broad money growth. He said that the latter has occurred in the last 2 years but the rise in corporate liquidity began in 2014. Peter Warburton said that the data did indicate a Brexit related pick-up in liquidity and that sterling and foreign currency deposits had also risen, showing a build-up in sterling and foreign currency holdings. He said that if the Brexit situation becomes clear then potentially corporates would use the liquidity for investment.

Easy money combined with a huge devaluation…providing monetary stimulus.

Patrick Minford said that the facts are that money supply growth has accelerated and the situation looks like easy money. He said that there is no reason to interpret the situation as anything other than one of easy money combined with a huge devaluation. Open economy macroeconomics says that the devaluation is providing a monetary stimulus that is now being reflected in the monetary statistics. There may be a puzzle in the labour market with wages being largely sluggish but the picture of monetary stimulus is consistent.

Composition effect of lower than average wage employment…

Andrew Lilico said that regarding the labour market, the economy has been adding to employment workers at below the average wage, depressing the average wage figures. So the figures are reflecting a composition effect. For the continued employed there has been an increase in wages at about 4.5% over the last 3 years. Admittedly when inflation was zero this had more force than now.

Patrick Minford said that this adds to the picture of general tightening in the labour market and referred to the noises coming out of officialdom about public sector pay and the possibility of a review commission that is reminiscent of the ‘Clegg Commission’ of an earlier period. We can expect some official capping of public sector pay. This suggests an eventual labour market tightening following a classic monetary stimulus. He said that as the SMPC we should be asking for a tightening.

Peter Warburton said that in the UK and globally, there is a nominal framework that is pointing to a modest increase in inflation. The idea that the world is teetering on the brink of a deflation does not stack up with the data.

UK monetary signals are stimulatory

Patrick Minford added that UK has a greater monetary stimulus than the rest of the world that is reflected in the exchange rate. John Greenwood agreed that the UK monetary trends are dangerously stimulatory, exacerbated by Bank of England QE policy of last year. The danger is that the UK is creating the potential for a domestically generated inflation and monetary restraint is needed.

Phillips where are you?

Andrew Lilico asked that if there is a danger of domestically generated inflation, why this is not reflected in bond market yields. Patrick Minford said that the bond market is discounting endless ‘Carneyism’ or further QE policy. John Greenwood said that the market view is that inflation is wage driven and not looking at the money supply. Patrick Minford said that the view that inflation is labour market driven and that low wage growth drives low inflation is a view that can change rapidly particularly with post-Brexit changes to immigration of the unskilled. John Greenwood said that he continues to receive reports entitled ‘Phillips where are you?’ addressing the question why under full capacity wage growth is weak. The prevailing view is that labour market conditions generate inflation and they fail to make the connection with money supply growth.

Phillips curve concept is misconstrued …

Transmission of wage pressure from the marginal worker to the average has changed.

Jamie Dannhauser said that the Phillips curve concept is misconstrued. He said that it is with the marginal worker, where workers are moving to new jobs, is where the pay pressures are being seen. The US publishes some data on this and he said that he was pressing the ONS to do the same. What has changed is the transmission of wage pressure from the marginal worker to the average. Survey data says that employers find difficulty in recruiting skilled labour and there is a willingness to pay higher but the puzzle is why this is not being translated to the average. It is likely that pay pressure will be in the job-to-job moves first before moving on to the rest of the labour market. So when it does go through to the average wage it is too late.

Immigration, wage pressure and the long and variable lags of the money supply…

Patrick Minford said the issue is about immigration. When the labour market tightens, the open border leads to a flood of unskilled immigration. When immigration tightens, post-Brexit, labour market conditions will change. Also there is the possibility that the lags are being ignored on the recent acceleration in money growth. Trevor Williams said that the recent M4 lending figures in the charts circulated by Peter Warburton shows that there is still some way to go to match the 1998 averages. He said that talking about long and variable lags, money supply growth has not been persistent and the need to react now is questionable.

Issues of mismeasurement and the fear factor from technological advance.

Roger Bootle said that regarding the absence of Mr Phillips, as economists we need to be aware of issues of mismeasurement. First there is the impact of immigration many of which is illegal and is not reflected in the figures. Second, there is the point made by Patrick Minford that employers know that if the labour market tightens they can always draw people in, which reduces the elasticity of response of wage increases to labour market conditions. But above that third, there is the change in technology that is making labour more cautious, and that this was as true in the US as in the UK so it is not a regional factor. Kent Matthews said that robotics had not changed productivity so this was a fear factor in the labour market that was working on wage growth. Roger Bootle said that he was wary of jumping to conclusions from labour market statistics and that there was an argument for waiting. Jamie Dannhauser added that the statistics have difficulty in capturing labour market flexibility, piecework, job-sharing etc.

Fiscal policy softening and ant-austerity political pressure…

Patrick Minford said that a further problem is that the Treasury is facing political pressure to ease off on austerity and he was afraid of policy softening as in the 1970s, when budgets didn't seem to matter and money supply was ignored. Roger Bootle said that if there were signs that the Treasury was going to 'throw in the towel' then there is a case for acting now but there is no sign of this. Andrew Lilico said that he expected a softening in fiscal policy but not 'throwing in the towel'. He said that the deficit was just below 3% and expected it to be in the 2-3% range and the situation is not so bad that requires significant tightening. Patrick Minford said that he was not asking for a significant tightening just a reversal of the ¼ point cut as a shot across the bows. Julian Jessop said that he agreed with Patrick Minford that what was needed was a shot-across-the-bows to signal to the government and left-wing Keynesian that policy was gradually tightening.

Corporate sector confidence and the political uncertainty.

Graeme Leach said that one of the issues was the weakening of confidence following the political scene. Jamie Dannhauser said that the interesting thing about the surveys on confidence is that while people report a slide in confidence regarding the economy as a whole, they are more upbeat about their own personal economic position. Graeme Leach said that he was concerned with corporate sector confidence in the context of the Brexit negotiations. Patrick Minford said that latest investment figures are optimistic. Peter Warburton said that sterling is not reflecting the potential disaster that could be the outcome of the negotiations and are assuming that somehow we would muddle through. Patrick Minford said that this was the likeliest scenario that there is an expectation of a transition period and payment of an exit bill otherwise sterling would have fallen through the floor.

Consumer sector must weaken to allow external sector to grow

Kent Matthews said that little was said about the external sector. He said that with the economy at almost full capacity he would expect the household sector to weaken as domestic demand scales back to allow for the external sector to grow in response to the devaluation. Andrew Lilico said that the devaluation has seen a rise in export values but not export volumes. Companies are sitting on their profits.

Votes

Trevor Williams brought the meeting to order and called for votes. As there were ten members of the committee present Kent Matthews reminded the meeting of the rules that the vote of the last person to join the meeting, who was Julian Jessop, would not be counted. As Julian Jessop is the IEA observer his vote would be counted only if there were fewer than the required nine but his views will be recorded in the Minutes. The votes were given in the order recorded in the Minutes.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%. No further QE
Bias: To raise

Why should interest rates remain at emergency levels?

Andrew Lilico said that you need good reasons for interest rates to remain at emergency levels. We don't have an emergency. If you don't feel you can raise rates when growth is at an average of 2% for several years, unemployment is 4.5%, monetary growth is 7%, and no particular credit problems or financial instability, when will you do it? He said that this is the ideal environment to raise rates. The only weakness is the pass-through effects of the currency depreciation. Any strengthening of the currency from the signal of raising rates is all to the good. Stable wage growth means that a currency appreciation will work faster on inflation. He said that **a rise in rates should signal the start of an interest rate rising cycle, a rise of ¼ is not enough as that could be interpreted as simply a reversal of the mistaken cut, so he voted for a rise by ½%.**

Comment by John Greenwood

(Invesco Asset Management)
Vote: Raise rates by ¼%. Close the QE window.
Bias: None

Danger of domestically generated inflation

John Greenwood said that his vote will be the same as in the past two meetings which is to reverse the ¼ point cut and freeze QE but not reverse it. The economy is going to be weaker but by cutting rates last August and injecting further QE the Bank of England is in the danger of creating the conditions for a rise in domestically generated inflation. **A ¼ point rise is enough to signal the start of the rise in interest rates. He said that he did want to reverse QE but he had a bias to raise rates.**

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate ¼% and reversal of QE
Bias to raise

Gradual tightening and shot across the bows

Patrick Minford said that he would like to see a gradual tightening. QE could be reversed by not renewing the up-coming maturities. Everything should be done gradually. He said that the small rise was essentially a shot across the bows. 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

Strong pick-up in nominal spending.

Jamie Danhauser said that he agreed with everything that Andrew Lilico had said but that he would vote for a ¼ point rise. He would also add three things. First that the EU economy is in a healthy state and recovering. The UK being a small open economy should not underestimate the impulse the EU economy has on it.

Second, he was concerned with the state of the labour market and that there were material recruitment issues. He said that nobody knew what the natural rate of unemployment is but that they would be taking a great risk if they thought it was much lower than 4.5%. He said that he was also uncomfortable with the continuation of emergency measures. He said that third, there has been a strong pick-up in nominal spending, entirely consistent with the money numbers. Consumers and businesses are feeling much better about the rise in costs from the exchange rate pressure. They are maintaining volumes and spending more in value terms as prices rise. **So raise by ¼% and happy to signal a continuation of rises in the future at a gradual pace.**

Comment by Julian Jessop

(IEA Observer)
Vote: ¼ point rise. Maintain QE but not yet reverse.
Bias: None

Zombie companies being kept alive by monetary policy

Julian Jessop said that he agreed with much of what had been said and voted to raise by ¼ point. He said that things are not as bad as what people thought they were a year or two ago. He said that it was important to signal to the consumer that it might be taking on too much debt or to signal to the government the dangers of loosening up on deficit reduction. Two other points he said he wanted to make are first, about why productivity has been so low. He said it is because of the number of zombie companies that have been kept alive by monetary policy. Second, that inflation is above target and is likely to rise in the year and a ¼ point rise will work to strengthen the exchange rate and put downward pressure on inflation. **So he voted for a ¼ point rise and to maintain QE**.

Comment by Graeme Leach

(Macroeconomics)
Vote: ¼% rise.
Bias: None and no change in QE

QE successful when money growth is 6-9%.

Graeme said that this was the first time he would be voting for a rise in the rate of interest in a long time. He said he was sympathetic with Roger Bootle's view. He said that when the Bank of England introduced QE that it would be halted when money growth was in the 6-9% range. Well it is now in the target range. He said that the confidence factors of businesses do not fill him with too much concern. He also recognised the signalling issues and the microeconomic distortions caused by the low rates of interest but took the view that macro issues dominated at the time. He took the point about Zombie companies and so **he voted for a ¼ point rise and no change in QE.**

Comment by Roger Bootle

(Capital Economics Ltd)
Vote: Hold Bank Rate.
Bias: to raise Bank rate

The economy faces considerable political uncertainty.

Roger Bootle said the economy is in a period of considerable political uncertainty. He said that he was not as confident as Patrick Minford that Brexit will go through. He had no prediction as to what kind of administration will be in power or whether the current administration would survive. He felt that given the political uncertainty that now would not be the right time to raise rates. He said that he was sympathetic to what has been said around the table and that he was very close to raising rate but he had not got there yet. **He said that his bias was to raise rates but he votes to hold them for the moment**.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: Raise Bank Rate ½ %

Challenge the view that the world will fall apart when rates rise.

Bias: To raise Bank Rate.

Peter Warburton said that he has been asking for a rate rise since February 2013. He said there is an institutional paralysis in the MPC expressing a view consistent with a long-term thesis. He said that he would vote along with Andrew and challenge the view that the world is going to fall apart because of the rise in rates. He said that the Fed had raised rates four times and the world has not fallen apart. There is a long overdue adjustment irrespective of weaker data in the near future **and it is entirely appropriate that interest rates should be raised by 50 bps with a bias to continue rising in small steps**.

Comment by Trevor Williams

(University of Derby)
Vote: raise by ¼%. End the QE Programme.
Bias: Neutral.

No inflation risk from the exchange rate or wages.

Trevor Williams said, as he did the last time, that he would vote for a reversal of the ¼ point cut. He said that he did not think there was any inflation risk from the exchange rate depreciation. It was a price level effect and was not being accommodated in domestic inflation. He cited low wage inflation, and that growth anyway was weakening. In addition, there are good reasons as to why wage inflation is low, like technology increasing capacity and changes in composition of the workforce. Current high single digit growth in money supply may not last. He favoured a reversal of the cut of last year, would be cautious about the timing of further increases but thought that QE should end, and reversed, by allowing the roll off of maturing debt.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate ½ %
Bias: to raise in small steps. Halt QE

Microeconomic and macroeconomic arguments coincide

Kent Matthews said he votes for a ½ point rise because he had consistently been asking for a ¼ point rise well before the cut last summer which he said was a mistake. He said that on the signalling argument that it seems the market is expecting a ¼ point rise at some time. Therefore it is a weak-signalling argument to simply validate what the market expects. The way to signal to the market that we are in a rising interest rate cycle is to raise rates beyond what the market expects which is to have a ½ point rise. He said that he has also been making the zombie point for a number of years as part of the microeconomic distortions created by low interest rates and now both micro and macro arguments are in conjunction. He **voted to raise rates by ½ % and continue to raise in small steps**.

Policy response

1. On a vote of eight to one the committee agreed to raise the rate by ¼%, and start a process of returning rates to some form of ‘normality’.
2. Three members voted to raise Base rate by 50bps. Five voted to raise by ¼% and one voted to hold.

3. There was a clear bias to raise rates.

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 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).