

Shadow Monetary Policy Committee

15th June 2018

Embargo: Not for publication before 00:01am Sunday 17th June

Shadow Monetary Policy Committee votes Seven / Two to Raise Bank Rate in June.

In its June 2018 e-mail poll, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of Seven to Two, to raise rates in June. One member voted for an immediate rise of 0.5%. Six favoured a 0.25% rise. Two favoured holding rates.

Advocates of raising rates acknowledged that monetary growth has recently been weak and overall economic performance has fallen back, but noted that the labour market remains strong and that the underlying case for some normalisation of rates away from emergency levels is not particularly affected by one or two quarters of weaker growth.

Advocates of holding rates noted that inflation has fallen back and seems unlikely to exceed the target on any sustained basis and in an environment of weak growth and poor productivity performance felt that a rate rise was hard to justify.

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.

For Further Information on the Content Please Contact:

Andrew Lilico + 44 (0) 20 7269 2644 andrew.lilico@europe-economics.com

Trevor Williams + 44 (0) 7841 497791 trevor@trevorwilliams.website

Julian Jessop + 44 (0) 20 7798 60192 jjessop@iea.org.uk

Votes

Vote by Phillip Booth

(St Mary University, Twickenham)

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

Bias: To tighten.

Vote and comment by Jamie Dannhauser

(Ruffer LLP)

Vote: Raise Bank Rate 0.25% and signal faster hiking cycle than market currently expects

Bias: to raise

The shadow of the Brexit negotiations continues to hang over the UK economy. Despite strong growth in employment, consumer spending growth remains subdued, a function of the ongoing squeeze on real household incomes as Sterling's post-referendum decline passes into retail prices. Business outlays have held up for certain quick-payoffs items – e.g. software & IT – but there is now abundant evidence that long-duration fixed investment has been restrained by Brexit-related uncertainty. For instance, excluding orders from the public sector, the flow of new business in the construction sector has slumped by 13% since June 2016, a figure that is dramatically inflated if housing-related activity, currently being pushed hard by the government, is excluded (<https://www.ons.gov.uk/businessindustryandtrade/constructionindustry/datasets/newordersintheconstructionindustry>).

However, sluggish demand growth is not a reason for monetary policy to remain loose. For one thing, the economy has already reached full employment, leaving limited scope for a period of above-trend growth. More importantly, however, weak demand growth is not the only reason the expansion in output is sluggish: the prospect of increased trade frictions with the EU, and potentially new trade links with non-EU countries, is forcing a reallocation of capital and labour towards new firms and new sectors, i.e. potential output is constrained also. Moreover, to the extent that households and firms expect Brexit to diminish the sustainable capacity of the British economy in the long-term (at least relative to the previous counterfactual), demand today is responding to expectations of weaker supply tomorrow. Put simply, the current subdued rate of growth is at, or possibly above, growth in the economy's supply potential.

In addition, there are tentative signs that demand growth is picking up. Consumer expectations about future income growth are at a two-year high, driven by a spike in the share of HHs that are "very bullish" about their personal finances. Similarly, there are signs of renewed momentum in the labour market, a challenge to the widespread perception that the UK economy will stay in the doldrums. Prospectively, the UK economy could grow above trend in the near-term, driving unemployment further below NAIRU and within-firm capacity utilisation further above normal. In the context of rising oil prices and commodity inflation more broadly and gradually firming wage growth, it is prudent for policy to become less accommodative. That is as much about an immediate rate hike as it is a signal about the path of Bank Rate. Any view on UK monetary policy is conditional on the outcome of Brexit negotiations; but in my view it remains inappropriate to hold fire on interest rates because of a low-probability tail risk. Were a damaging hard Brexit to take place, the Bank could respond in real-time, balancing the inflationary impact on a further lurch down in Sterling against the likely deflationary shock that would arise from increased uncertainty and tighter financial conditions (as GBP risk premia rise).

Vote and comment by John Greenwood

(Invesco Asset Management)

Vote: Raise rates by 0.25% but lower the countercyclical buffer and leverage ratio.

Bias: None.

In August 2016 when the MPC expanded QE by £60 billion (to £435 billion), cut rates to 0.25% and introduced the Term Funding Scheme it rapidly became evident that the Bank was stimulating an economy that was already in the throes of a strong expansion. Bank lending and M4x growth had both been accelerating since early in the year, and real GDP surged to over 0.7% (or 3.0% annualised) quarter-on-quarter by 2016 Q4. The effect was to exacerbate the imported inflation following the post-referendum depreciation of sterling.

After holding up well for a while, due in part to the excess growth of money and credit in 2016-17, the UK economy has subsequently moved in the opposite direction as the short-term uncertainties associated with Brexit have weighed on investment sentiment, and declines in real wages due to higher import prices have eroded consumer spending. While the performance of some of the externally oriented sectors has been reasonably buoyant (such as technology and fin-tech), this has not been enough to outweigh the negative impact of the two big drivers of domestic economic activity – consumption and investment spending.

During the past twelve months money and credit growth have slowed abruptly. M4 growth has slowed from 8.3% year-on-year in April 2017 to 1.1% by April 2018, while M4x growth has slowed from 7.4% to 3.3%, and M4 lending has declined from 6.1% to 2.5% over the same period. Nevertheless, concerned at the rapid growth of consumer credit (which comprises less than 10% of M4 lending), in June 2017 the Bank's FPC announced an increase of banks' countercyclical capital buffers from zero to 0.5% (and to 1% in November) each effective one year later, and an increase in the required leverage ratio by 0.25 percentage points from 3.0% to 3.25% of banks' aggregate balance sheets. In November the MPC announced a 0.25% increase in Bank rate to 0.5%, reversing its decision of August 2016.

The Bank's macro-prudential ratio tools are still relatively untested, and – in contrast to interest rate adjustments which normally have gradual and progressive effects -- could well be the source of the recent dramatic downturn in money and credit growth. For example, the countercyclical buffers required an additional £11.4 billion of capital, but an easier way for banks to achieve the required ratios is simply to reduce total lending by some multiple of this amount.

Meantime, inflation as measured by the headline CPI has declined from 3.1% in November to 2.4% in April, while the core CPI has slowed from 2.7% in November to 2.1% in April. Given the recent monetary slowdown, there is no imminent threat of domestically-generated inflation and therefore no need to raise interest rates on June 21st. However, since it would be better to return to a policy of adjusting interest rates as the primary policy tool rather than making such frequent adjustments to capital ratios, I would prefer to raise rates (by 0.25% to 0.75%), but lower the countercyclical capital buffer and the leverage ratio.

Vote and comment by Julian Jessop

(IEA)

Vote: Raise 0.25%

Bias: to Raise

The latest business and consumer data confirm that the economy has picked up some steam again after stalling in the first quarter. Signs of weakness in the

monetary aggregates, weaker external demand, economic and political uncertainty in the euro area, and the risks of renewed uncertainty from the Brexit talks will all need watching. But the bigger picture is still that interest rates no longer need to be held at emergency lows.

Vote by Graeme Leach

(Macronomics)

Vote: Hold Bank Rate; Hold QE

Bias: Neutral

Vote by Andrew Lilico

(Europe Economics)

Vote: Raise 0.25%

Bias: to Raise by 0.25% each month until rates reach 2%

Vote and comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Increase Bank rate by ¼%

Bias: Raise further, discontinue QE and reverse gradually.

It remains a popular view among forecasters that 'uncertainty' about Brexit must undermine UK economic growth. Economic surveys have looked for evidence that it has reduced investment. This evidence has been weak and elusive, as illustrated by the CBI survey which has found continued robust prospects, and no sign of investment weakness. On consumption similarly Brexit has supposedly reduced consumer confidence and spending. But again the evidence we have is that consumers have reacted logically to higher consumer prices brought on by devaluation and spent less; but this is an inherent part of the 'demand switching' that devaluation should bring in order to correct our large balance of payment deficit.

When we look at UK economic growth what we see is that employment has risen to a record high level and unemployment fallen to rates close to 4% indicating full employment. It is hard to argue that without Brexit there could have been 'more than full' employment.

As for the growth in UK output that is equal to effect of rising employment plus the effect of productivity growth. Much ink has been spilt on the productivity puzzle of slower growth but the slowdown antedates Brexit by nearly a decade. Free trade should lead to faster productivity growth due to increased world competition; but that effect cannot kick in until free trade deals have been signed. Meanwhile how could Brexit affect productivity? Some might argue from some fall in investment: but as we have seen evidence for this is weak, and at most the effect could be a couple of percent. Since investment typically runs at around one twentieth of the capital stock, this would mean a capital stock trivially smaller, with a de minimis effect on output.

With employment 'full' and so a tight labour market, it remains the case that monetary policy should revert to 'normal' from 'emergency loose' which is where it now is. It is astonishing that the MPC still delays this normalisation, as if the economy is begging for enormously loose money for the indefinite future. One wonders what cataclysm on inflation or wages would be needed to shift this MPC inertia. My request as before is for interest rates to rise gradually and QE to be reversed, also gradually.

Vote and comment by Peter Warburton

Economic Perspectives Ltd)

Vote: Raise Bank Rate by ½%

Bias: to raise Bank Rate in steps of ¼% to 1½%

At the end of October 2016, Mark Carney extended his term of office until the end of June 2019 to “help contribute to securing an orderly transition to the UK’s new relationship with Europe.” In his 24 May speech, “Guidance, Contingencies and Brexit”, the governor confirmed his obsession with Brexit and his parallel desire to micro-manage the UK economy.

Undeterred by the Bank’s rash response to the June 2016 referendum, Mr Carney is back on the front foot. “My message this evening is straightforward. From a monetary policy perspective, the Bank of England is ready for Brexit whatever form it takes.” He identifies two potential policy paths: a central projection which assumes a smooth transition to a “Brexit that is the average of a range of outcomes” (whatever that means) and a sharper Brexit involving either a disorderly transition or an end-state agreement that is materially worse than the average potential outcome, or both. In the latter case, he is clearly warning that the Bank is considering a repeat dose of the knee-jerk response that it gave in August 2016, when Bank Rate fell, QE was resumed and the Term Funding Scheme was introduced.

At the heart of this misguided strategy is the notion that monetary policy settings map on to unique outcomes for the UK economy, as they do in the models. If the Bank was still in a 1970s world, pulling levers in a railway signal box, then all would be well. However, a better metaphor for the Bank in 2018 sits in the middle of a wiring diagram, where policy has influence but not control. Through its own actions and by its own faults, the central bank has become endogenous to the economic and financial system.

This means that the impact of a given policy change is dependent on the expectations and reactions of households, businesses and financial institutions. The evolution of UK output growth and inflation over the past 5 years does not validate the decision to hold Bank Rate from 2013, in violation of the counterfactual path suggested by historic correlations. There was clearly a middle road to be taken, acknowledging the ongoing need for structural repair, but seizing the opportunity to begin the normalisation of policy. I contend that the UK economy would be in a much stronger and healthier position today – to confront whatever terrors Brexit may or may not hold – had tightening begun 5 years ago. “Guidance” has endogenised policymaking and thereby diminished its effectiveness.

UK monetary trends remain subdued, but not unduly worrying. Broad money and broad lending growth rates in the region of 3%-4% per annum appear low, but are distorted by the Term Funding Scheme. Despite rumblings of consumer discontent, it is time to get on with the first stage of rate normalisation, towards a Bank Rate of 1.5%.

Vote and comment by Trevor Williams

(University of Derby)

Vote: Hold Bank Rate

Bias: Neutral but stop reinvesting maturing QE debt

M4 money supply growth has weakened markedly in the last couple of months. It cannot be a coincidence that this is happening just as the pace of growth in the real economy has also slowed.

Banks risk appetite may not have declined, but they now have to hold more capital against every loan offered and so lending growth may slow in the months ahead. Besides, the real economy is operating below an already poor trend rate of growth. It is hard to ignore the fact that UK growth is underperforming the global average, and seems to be becoming less competitive, perhaps due to reduced productivity growth. Price and wage inflation, in my view, is not the primary concern in this environment, as there are few signs of any resurgence. Making economic conditions worse by raising interest rates does not seem sensible at this time. Best to wait and see how things unfold over the summer.

Policy response

1. On a vote of seven to two, the Committee voted to raise Bank Rate.
2. One member voted for an increase of 0.5%. Six members favoured an increase of 0.25%. Two favoured holding rates.
3. By convention, there is, therefore, a decision to raise rates by 25bps

Date of next meeting

17 July 2018

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 (Ruffer LLP), 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 (University of Manchester), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School).