Shadow Monetary Policy Committee

9th September 2018

Embargo: Not for publication before 00:01am Sunday 9th September

Shadow Monetary Policy Committee votes Six / Three to Hold Bank Rate in September.

In its September 2018 e-mail poll, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of six to three, to hold rates in June. The three favoured a 0.25% rise.

Advocates of holding rates noted that the Bank raised rates last month and that broad money growth was relatively weak, which they interpreted as indicating no urgency about the next rise. Most did, however, have a bias to raise in due course with November being a favoured date.

Advocates of raising rates noted that the UK economy continues to grow steadily, that concerns about the impact of Brexit should not deter policymakers from continuing the process of monetary policy normalisation now, and that because several rises were needed and the Bank only raised rates 0.25% in August, the recent rise is not a good basis for not raising rates steadily furthers.

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

Votes

Vote by Phillip Booth

(St Mary University, Twickenham)
Vote: No change.
Bias: To tighten.

Vote and comment by John Greenwood

(Invesco Asset Management)
Vote: No change.
Bias: None.

M4x money growth has slowed from a 6.5-7.5% growth rate of mid-2016 to mid-2017 to just 3.4% year-on-year in July. The economy is growing steadily, but probably below its potential. Although employment and the labour market are still buoyant, wages remain subdued and real earnings growth has been barely above zero. Inflation is falling back to the Bank's 2.0% target as a result of the decline in imported inflation, but is unlikely to fall much further in the near term due to the monetary stimulus of 2016-17, weak sterling, and a pipeline of prospective cost increases this autumn. In this environment I vote for no change in rates.

Vote and comment by Julian Jessop

(IEA)
Vote: No change
Bias: to Raise

The Bank raised rates as recently as August, so there is no rush to move again. The incoming data have supported last month's decision: GDP grew by 0.4% q/q in Q2 and the latest surveys point to a similar performance in Q3; the labour market continues to tighten; and inflation is still above target. Against this, Brexit uncertainty is increasing again and there have been further signs that the global economy is weakening. It therefore makes sense to wait until the next quarterly Inflation Report in November before seriously considering another move, though the case for further gradual increases to take rates back to more sustainable levels remains as strong as ever.

Vote by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate; Hold QE
Bias: Neutral
With broad money M4x growth having fallen back to around 3.5% (12 month growth rate and 3 month annualised), there is little need to tighten monetary policy further, given that the impact of the most recent August rate increase is yet to work though.

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise 0.25%, reverse QE (QT) until CPIH-adjusted gilt yields are positive
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, reverse QE (QT) gradually.

The political classes are in uproar, arguing over the various possible forms of Brexit, including one with no EU trade deal at all, exiting under WTO rules. Yet the economy sails on serenely, clocking up yet more record employment, with inflation coming down towards its target, interest rates finally rising, productivity recovering, the balance of payments improving and growth proceeding close to 2%. The pro-Remain media trumpet the 'uncertainties' and even the possible 'terrors' of no trade deal; and noone takes any notice apparently, outside the usual representatives of 'industry' such as the CBI.

What on earth is going on? We sometimes hear from pundits that ordinary people are ignorant of economic issues. Yet when we check the behaviour of their economies we typically find that their expectations are rational. This is not surprising since it is their interests that are at stake; and it is a stupid person indeed who ignores his or her very own interests.

The truth is that ordinary people have got this right: they realise that for all the posturing by politicians trade will continue largely undisturbed by Brexit but that Brexit will bring some longer term trend changes that they have by a substantial majority approved. Nor are they worried that the government will somehow renege on 'full Brexit'. The British have enormous confidence in their democracy. They know full well that no government can survive by standing out against settled public opinion. The Conservatives are now reacting sharply to the unpopularity of this government's Chequers proposals which have greatly alienated the referendum majority and caused a swing away from the Conservatives that could be sufficient to let in a Corbyn government.

With these proposals now clearly unacceptable, where will Brexit go? There are two possibilities: exit under WTO rules or a Canada+ trade deal. Both offer a full Brexit as demanded by the referendum result; both produce a long term economic gain for the UK economy, with free trade, own-regulation, control of borders, and no further budget contributions. Under WTO rules though the EU stands to lose a lot: no transition budget contribution, substantial tariff payments to the UK Treasury, and Brexit effects damaging their trade returns coming two years earlier. Their loss is largely the UK's gain. It seems likely enough that as this possibility becomes a reality, the EU will be happy to switch to Canada+. The irony of the present negotiations between the EU and the UK government within the Chequers framework is that the discussions can easily be 'pivoted' into a Canada+ framework where essentially the same 'access' will be achieved, but without the paraphernalia of the Chequers-proposed 'EU rulebook'. This simply cannot ultimately be agreed by either side: ours because it requires foreign rule, the EU's because it does not include the 'fourth freedom' of free migration.

The Bank of England has now reconciled itself broadly to Brexit. It is now eager to retake its role as regulator of the City in world markets. In its monetary policy judgements it is returning to normal analysis, arguing that whatever the trends in the economy due to non-monetary factors such as Brexit or productivity drivers it is simply their job to control inflation, not to try and use monetary policy to offset such trends- which it is incapable of affecting anyway in anything other than the very short term.

The last policy shoe to fall is the Treasury. This remains unreconciled to Brexit. In this attitude it reminds one of the Treasury in the very early years of Mrs. Thatcher, unreconciled then to her monetarist policies. Then as now it staged a mandarin rebellion. After a decent interval those mandarins had to go, having totally misjudged the democratic mood.

The Treasury is playing the game of announcing doomladen forecasts still. Yet as Denis Healey memorably remarked 'when in a hole, stop digging'. The Treasury's predictions of doom were so badly wrong that they are entirely discredited as a forecasting organisation- even the new Brexit secretary has poked fun at them. Embarrassingly for the Treasury, in their home area of revenue, the money now keeps pouring in. The PSBR keeps on contracting, with the latest forecast for 2018-19 coming down to £30 billion, 1.5% of GDP, with the public debt/GDP ratio now having fallen steadily since 2015 (remembering to use the right debt definition, which must exclude all the Bank of England's market operations).

It is high time the Treasury came round to accepting Brexit and making policy to optimise our economic prospects, building on the free trade and potential deregulation it will bring. For all the Remain efforts to defend our position within a protectionist EU, the truth has always been that free trade brings benefits in the form of lower prices and more competition. Furthermore this freedom does not need to come at the expense of barriers with the EU: even under WTO rules these barriers will consist solely of tariffs which are in general fairly low but under Canada+ they will be effectively non-existent. In any case once our markets are open to the world, any barriers with the EU will have an insignificant effect on our economy.

In the Economists for Free Trade 'Budget for Brexit' the possibilities for imaginative Treasury policies on tax and public spending were carefully set out. For this Conservative government they suggested that at last the Treasury could get away from its position of endless austerity and create opportunities for greater growth.

With plenty of excess capacity in world raw material markets the world outlook remains good for a long period ahead. The main challenge for the UK is to create growth from rising productivity now that the economy is hitting up against the limits of full employment. Some of this will occur naturally but after long years of austerity and a negative approach to growth-friendly policy the government now has a good chance to grasp the growth-creating opportunities from Brexit. Improved infrastructure, reformed funding of the NHS, and tax cuts can all usher in a new environment that will build on the extra productivity coming directly from Brexit itself.

The usual round of 'Brexit analyses' from City and other firms continues- 'showing' that growth has been lower than it would have been because of Brexit. The favourite method, used by several before including the Bank of England and now recycled by UBS in a recent offering, is to create a 'comparator group' of countries and to compare their growth and other behaviour with that of the UK. These countries can be a variety, such as euro-zone or north American. The problem with this method for judging business cycle behaviour is simple and damning: cyclical experience is highly individual if one is judging percent changes over very short periods. Consider for example how specific the euro-zone experience is compared with the UK: weathered the early financial crisis well, then the euro's own crisis hit, then there was a late burst of QE from the ECB, finally it is coping with difficult banking problems across the zone but especially in Italy. Or the US with its 'Trump effect'. The margin of error due to non-comparable features is simply too great to estimate differences in short term growth of a few percent. The method has reasonable validity when one looks at long periods of growth: for example if you compare the much faster growth of mainland Europe from 1945 to 1979 with the UK's you can reasonably treat this as evidence that we failed to achieve our potential during that period. In this case of a long period of history enough features of the two economies are similar to use the difference in long run growth to support good analysis based on economic modelling.

I have argued before that it is hard to ascribe any significant 'demand effect' to Brexit when the UK economy keeps on setting employment records in the region of full employment: could we have got 'more than full' employment without Brexit? On the supply side, any effect on investment would have only a miniscule effect on the capital stock (this being some 20 times the size of investment). As for productivity how could Brexit affect that, a longstanding 'puzzle' since the financial crisis hit? Brexit will have its long run effect on the supply side once it comes in. We will then be in a position to judge whether free trade has brought a productivity gain or whether a ‘gravity effect’ of distancing ourselves somewhat from the EU comes into play to offset it.

Meanwhile the business of normalising monetary conditions needs to continue with due deliberate speed. As I have argued before, now that the economy is plainly not in the financial crisis situation any more, crisis monetary policy must be brought to an end. Interest rates need to go on rising and the Bank needs to sell its government bonds.

Vote and comment by Akos Valentinyi
(University of Manchester)
Vote: Hold Bank Rate; Hold QE
Bias: No bias

Vote and comment by Peter Warburton
Economic Perspectives Ltd)
Vote: Raise Bank Rate by ¼%
Bias: To raise Bank Rate in steps of ¼% to 1½% and announce the phased reversal of QE

Speculation about the disruptiveness of the UK’s planned exit from the EU has overshadowed sober assessment of the UK economic outlook over the past 2 years, and this is likely to continue for at least another year. Standing back from the fray, my conviction is that the UK’s international standing will be undisturbed by EU exit. By this I mean, primarily, that the excellent access that the UK enjoys to international capital markets will be uninterrupted. There is every likelihood that the UK government will run larger budget deficits over the next few years than if the UK had remained in the EU. All manner of duplicated costs and transitional sweeteners will be offered to placate injured parties as the UK establishes parallel capabilities to those formerly contained within EU membership.

Because the UK has retained its own currency, its own unique financial market architecture, its own statute book, jurisprudence, trading practices and traditions, it has also retained its own character in international capital markets. The appeal of UK markets and the ownership of UK assets is separate from its status inside or outside the EU. There is an argument that an independent UK is a less attractive investment destination, a less desirable production location or that UK companies are less welcome participants in European supply chains, that might justify a larger risk premium, but that is an empirical matter. Far more important is that the UK government adopts sound economic policies, eliminates barriers to trade, commerce and capital and embraces new trading platforms and payment technologies. Freedom is only valuable if it is wisely used.
Between March 2016, the last full quarter before the Brexit referendum, and end-March 2018, the latest data point, the value of total net direct investment in the UK has risen by 24 per cent, against an increase of 11 per cent in total direct investment abroad. Total portfolio investment in the UK is 14 per cent higher than in 2016Q1 versus a 15 per cent increase for total portfolio investment abroad. Other net investment (including property assets) in the UK is up 17.5 per cent, versus a 20 per cent gain for other investment abroad. On balance, the UK’s net international position is only a little worse than 2 years ago. Far from shunning UK business assets, overseas companies and investors have stepped up their ownership since the referendum.

Nor have UK companies struggled to raise finance since June 2016. Net loan and bond issuance has been broadly constant at around £30bn per annum for more than 3 years. As a further investigation of credit supply to the UK economy, we have updated and extended our credit impulse analysis to incorporate net capital market credit issuance as well as bank loans. The credit impulse for Sterling bank lending to the private sector (excluding other financial corporations) can be calculated on two bases. One, drawn from table A2.2.3 of Bankstats, covers all monetary and financial institutions’ lending to the private sector, and the other, drawn from table C1.2 of Bankstats, covers UK-resident monetary and financial institutions' lending to private and public sectors. Post-2009, there is very little difference between the two measures. Both trace out a distinct downward drift in the bank lending impulse during 2016-18, indicative of economic stagnation.

However, when combined with the credit impulse for net capital issuance, a more hopeful picture emerges, consistent with the profile of PNFC financing from all sources. Rather than a downward drift, the overall UK non-financial credit impulse has perked up in recent quarters, setting the scene for a continuation of trend output growth in the region of 1 per cent to 1.5 per cent per annum.

UK monetary trends remain subdued, but not unduly worrying. The Bank of England Monetary Policy should be emboldened by the non-reaction to its August 25 basis point raise and get on with the job. The next 3 quarter points should be executed mechanistically to return Bank Rate to 1.5%. An announcement of the phased reversal of the QE programme, initially to withdraw the £60bn added in 2016, should be made as soon as possible.

Vote and comment by Trevor Williams
(University of Derby)
Vote: Hold Bank Rate
Bias: Raise
The UK economy is operating below potential. Headline GDP growth is flattering to deceive. Manufacturing is in recession as world growth slows from a peak. Productivity gains remain flat. Consumer price Inflation is falling gradually to the 2% annual target. Money supply growth is between 3 and 4%, consistent with weak expansion and low price inflation pressure.

Real pay growth meanwhile is flat or negative as nominal pay growth stabilises below 3, contrary to Bank of England forecasts and refusing to respond to low unemployment rates. Meanwhile, Brexit and political uncertainty remain the backcloth to the economy.

Policy response

1. On a vote of six to three, the Committee voted to hold Bank Rate.

2. The three members preferring to raise rates favoured an increase of 0.25%. Three favoured the commencement of quantitative tightening.

3. By convention, there is, therefore, a decision to hold rates.

Date of next meeting

16 October 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).