

# Shadow Monetary Policy Committee

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28<sup>th</sup> October 2018

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## Brexit uncertainty means Shadow Monetary Policy Committee votes Six / Three to Hold Bank Rate in November.

At its meeting on 16<sup>th</sup> October 2018, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of six to three, to hold rates in November. The three favoured a 0.25% rise. All members had a bias to raise.

Advocates of holding rates noted the uncertainty about the Brexit deal (if any) that the UK and EU would do, and the economic implications thereof. They suggested there would be ample opportunity to raise rates later if matters evolved relatively smoothly. In the meantime, there was no urgency, since inflation is well under control and falling. Some also cited the weakness of broad money growth.

Advocates of raising rates noted that the UK economy continues to grow steadily, argued that concerns about the impact of Brexit should not deter policy-makers from continuing the process of monetary policy normalisation now, and that since interest rates remain far below any plausible estimate of their neutral level monetary policy continues to be highly accommodative. The burden of proof should be on those arguing against raising rates, rather than those advocating an increase.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997, with a briefer e-mail poll 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.

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## Minutes of the meeting of 16 October 2018

**Attendance:** Roger Bootle, Phillip Booth, Juan Castaneda, Julian Jessop (IEA Representative), Graeme Leach, Andrew Lilico (Chairman), Kent Matthews (Secretary), Peter Warburton and Trevor Williams.

**Apologies:** Patrick Minford

**Chairman's comments:** Andrew Lilico welcomed Juan Castaneda to the Committee and his first meeting of the SMPC.

Andrew Lilico asked Graeme Leach to present the world and domestic economic background.

### World Indicators

World economic outlook softening on trade tensions, and oil price developments.

Graeme Leach began by referring to the October 2018 IMF World Economic Outlook projections for 2018 and 2019. The figures showed a slight softening of global growth projections, mainly due to potential trade tensions. IMF simulations suggest that whilst the current impact of protectionist measures is small - amounting to around 0.2 percentage points off global GDP growth – but the impact could get progressively more damaging if retaliatory measures escalate, business confidence falls and financial markets begin to slide.

Political uncertainties add to the downside economic risk, with the potential spike in oil prices, if the political crisis surrounding the death of the Washington Post correspondent in Turkey intensifies.

Turning to the USA, he said that potential inflationary pressures are apparent in unemployment figures, skill shortages and tight supply lines. However, despite this, inflation has come off the boil and broad money M3 growth continues around 5% (yr-on-yr). Based on the performance of broad money growth, Graeme Leach said that it is hard to see where sustained inflationary pressure is going to come from.

Serious financial risk to the global economy... explosion in China debt to GDP.

He also highlighted the downside risk to the world economy, emanating from a number of sources: (1) A financial crisis in China, due to the surge in private sector debt over the past decade. Historically, explosions in debt of the magnitude experienced in China, have almost always ended in financial crisis. There are also strong fears that the true levels of debt are far higher than shown in official figures. (2) A sharp fall on Wall Street, in the wake of recent equity market weakness. Measures of US equity market valuation, such as the cyclically adjusted price earnings ratio (CAPE) continue to look very expensive compared with the historic 10 year moving average. (3) Concerns that problems within the Italian banking sector could trigger a resumption of the euro crisis. The Italian 'death cross' with declining nominal GDP growth relative to trend, and rising non-performing loans, risk a systemic crisis.

### UK economy

Broad money growth falling....

On the UK, he said that the most important economic variable at present is M4<sup>x</sup> broad money growth. M4<sup>x</sup> growth has fallen to just 2.8% (yr-on-yr) and raises the spectre of further quantitative easing not tightening. However, the weakness may only be temporary and so doesn't warrant any immediate policy response. Graeme argued that this was the key downside risk to the UK economy at present, and that it would be highly unusual to raise interest rates when monetary growth was this low. A whole swathe of economic indicators across consumer confidence, retail sales and PMI surveys, point towards continued economic growth around current rates.

Of course, the great uncertainty at present is the impact on business confidence of Brexit over the next 6 months. Deal or no deal, and the nature of any deal remain uncertain, but the downside risk is almost certainly overdone, and once Brexit has actually happened there could be a bounce-back in economic activity, with previously postponed investment decisions put into practice. Regardless of the nature of any deal or otherwise, a degree of media hysteria - such as occurred with Y2K – is to be expected in the run-up to the end of March 2019.

...flat housing market

Reluctance to make big ticket item purchases may partly explain the weakness of housing transactions, due to uncertainty surrounding Brexit. Here again there could be a bounce back once the UK has left the EU, but affordability measures remain expensive and therefore a constraint - particularly in the South East - even allowing for low debt servicing costs.

### Comments

Andrew Lilico began the discussion by asking Graeme Leach to square the story of a slowing in the UK economy but still being at or above trend. Graeme Leach stated that there had been a 'summer sun' effect on certain categories of consumer spending, such as eating out, but that this temporary boost to economic growth had not been very strong. Moreover, broad money growth was a forward looking indicator, and indicated a slowdown in GDP growth in early 2019.

UK real side robust but monetary side weakening.

Andrew Lilico said that alongside the figures for broad money growth, there is the fastest growth in earnings since the latter part of 2016. Inflation looks to be coming down. Brexit uncertainties could be sorted in the coming days, one-way-or-another. The economy is at the lowest unemployment and we could be approaching some sort of natural rate, which explains the acceleration in wages. He asked if Graeme Leach was being overly pessimistic in the picture he was drawing. Graeme Leach said that he accepted that Andrew's scenario could come to pass but that it was unlikely if broad money growth continued to be so low.

Julian Jessop said that there was also the issue of productivity. Without a pool of cheap labour, firms are going to have to invest which will increase productivity, which in turn pays for the higher wages. He said that, that was the virtuous circle that had been missing from the UK for the last 10 years. Graeme Leach said that there had not been any productivity upturn of any significance. Julian Jessop, Andrew Lilico and Graeme Leach agreed that the most recent figures showed a small improvement and that the OBR would probably revisit the figures in the near future.

China slowing, and US asset prices overvalued...

More optimistic about UK

Andrew Lilico said perhaps there is a more positive picture in the global economy particularly in the performance of the US economy. Julian Jessop said that the US was responding to the fiscal stimulus which is likely to be only temporary. Roger Bootle said that he was more optimistic about the UK than the world economy. He said that on the US, the fiscal stimulus has been working but it has not had the uncertainty of a Brexit, or the effect of a devaluation which the UK has experienced. Meanwhile China is slowing. US asset prices look overvalued. So it is difficult to be optimistic about the world economy. He said that here was a story about the UK. He said access to cheap labour from Europe has meant that firms have not invested enough. Now there is Brexit uncertainty, but with the loss of cheap labour, real wages will start rising as the labour market tightens. He said that there was a story of optimism for the UK economy but less so for the world.

Andrew Lilico asked if there was a breakdown in relations with Saudi Arabia what could happen to oil prices? Julian Jessop said that the world economy is getting less and less responsive to oil price changes and, while another surge above \$100 would have a temporary effect by rattling confidence, in the case of the US it would be positive with a boost to shale oil.

Peter Warburton said that one feature of the US is the tight inventory position in goods. He said that it is possible that supply constraints are stopping the US from re-stocking but that the US could easily grow from stockbuilding returning to normality. He said that it was to be expected that inventories would be depleted after the rapid growth in the second half of last year. However, in 2018, the inventory position is leaner still. He said that he had no explanation for this, other than the possibility that it is due to distortions relating to the imposition of tariffs on China. He said that it could also be due to over-bearish sentiment towards China.

Andrew Lilico moved the discussion on to the Eurozone. Graeme Leach said that there is a political dimension with regard to Italy. Andrew Lilico and Roger Bootle discussed the possibility of the Italian government accepting an EU programme. Roger Bootle said that the Italian crisis has deepened and the debt to GDP ratio in Italy has worsened. He said that there was deep disenchantment with the European project in Germany, France, and Italy.

Target 2  
balances nearly  
25% of German  
GDP.

Juan Castaneda said that another issue is Target 2 balances which are now openly discussed in Germany. In Italy and Spain these balances are larger. These balances are nearly 30% of German GDP and no one knows how these balances are to be settled.

Andrew Lilico asked if the money supply figures could be seen as exogenous or endogenous? He asked once wages start to grow would the monetary figures respond positively? Phillip Booth said that to some extent the demand for money also responds to asset prices. Roger Bootle said that on an intellectual battle between money numbers and wage numbers for inflation he knew which side he was on. Banks are less relevant to the corporate sector these days. On the signals provided by the money numbers, he said that a case in point was the 1980s when the banks were distress lending to the corporate sector, boosting money growth but the economy was weak.

Juan Castaneda said that there were possibly two exogenous factors that are relevant. First, the phasing out the Bank of England's funding-for-lending scheme and second, the increase in bank capital ratios. This can explain why money growth is weak. Roger Bootle said that it does not explain why the economy is still strong. Juan Castaneda added that there is a delay in the effects of the current weak money growth figures on prices and output, so the effects will be noticed in 2019 and 2020. Julian Jessop said that the corporate sector could be using its surplus cash balances to support spending rather than borrowing from the banks. Juan Casaneda also commented that bank lending to SMEs has been falling.

Andrew Lilico asked what the short-term effects of a no-deal would be? Roger Bootle said that for a few months, there will be a barrage of bad news but after a few months as the major trade deals come in, there will be a bounce back. Andrew Lilico speculated that the best thing to do is to announce £39 billion of tax cuts if there was a no-deal. Julian Jessop gave examples of EU organisations already working in advance of a possible no-deal to mitigate the impact.

Andrew Lilico called the discussion to an end and asked what the prospect should be for interest rates and monetary policy?

**Votes are recorded in order they were given**

**Comment by Graeme Leach**

**(Macronomics)**

**Vote: To Hold**

**Bias: To raise.**

Graeme Leach said that the combination of weakening broad money growth and political uncertainty surrounding Brexit meant that interest rates should remain on hold.

### **Comment by Julian Jessop**

**(IEA)**

**Vote: Raise Base rate ¼%.**

**Bias: To raise.**

Julian Jessop said that interest rates had remained abnormally low. Keeping rates at this level is counterproductive. Inflation is above target, the labour market is continuing to tighten, and the economy is growing well. While there will always be risks out there, there has to be a return to normality in monetary policy

### **Comment by Roger Bootle**

**(Capital Economics)**

**Vote: To Hold.**

**Bias: To raise.**

Roger Bootle said that the main reason for his vote hold rates is Brexit uncertainty. Once the fog is cleared he expects to vote for significant rises in interest rates next year, as the economy responds positively.

### **Comment by Kent Matthews**

**(Cardiff Business School, Cardiff University)**

**Vote: To Hold.**

**Bias: To raise and unwind QE.**

Kent Matthews said at the last physical meeting he changed his traditional recommendation of a rise of 50 bps to 25 bps because of Brexit uncertainty. This time the noise from uncertainty has increased and he said that a no change was warranted. He accepted all the arguments as to why Base rate should rise but the political uncertainty of Brexit created an issue of timing. Once it is clear what the deal with Brexit is, he expected to resume his call for regular rises in Base rate in small steps.

### **Comment by Juan Castaneda**

**(Institute of International Monetary Research and University of Buckingham)**

**Vote: To Hold.**

**Bias: To wait.**

Juan Castaneda said that the weak money supply figures if continued in the coming months will indicate even a fall in GDP growth in 2019 and 2020. For this reason he expressed caution with no bias and to hold interest rates.

### **Comment by Trevor Williams**

**(University of Derby & TW consultancy)**

**Vote: Hold.**

**Bias: To Raise and to reverse QE.**

Trevor Williams said that it would be good to get rates back towards some normality which was possibly 2-2.5%. However, the economy was weak enough to keep interest rates on hold. He said the short run fall out of a no deal was not a matter of months but could be longer. The context for the UK economy in the next few years with the world economy slowing is different from when it voted to leave, when the world economy was doing well. He said that there were many supply-side issues including the danger of a Corbyn victory, but the demand-side issues were also strongly affected from the political uncertainty of Brexit.

### **Comment by Phillip Booth**

**(St Mary's University)**

**Vote: Hold.**

**Bias: To raise.**

Phillip Booth said that he recommended no change for different reasons. He said that we have had low interest rates and an expansion in base money. But whatever one's views about the importance of broad money, low and falling broad money growth could not be ignored and should indicate caution in raising rates. He said that a tight labour market did not necessarily imply inflationary pressures. After all, most people would have argued that the labour market has been tight for some years. Low unemployment is a reflection of other factors.

### **Comment by Peter Warburton**

**(Economic Perspectives Ltd)**

**Vote: Raise Bank Rate ¼%.**

**Bias: To raise.**

Peter Warburton said that, despite the high-profile tightening of monetary policy in the US, global credit conditions remain extremely slack, fostering multiple contexts of capital misallocation. Financial stability concerns have begun to rise to the surface again, giving greater urgency to the continuation of interest rate normalisation in the UK. While the deceleration of M4 lending is a troubling development, it must be considered against the background of consistent growth of corporate sector borrowing from all sources. The UK economy has performed better than expected this year, taking into account the very weak growth of real wages. There is virtue in raising Bank Rate while we can. He expects fiscal policy to loosen over the next 2 or 3 years, providing cover for monetary policy tightening.

### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: Raise ¼%.**

**Bias: To Raise and reverse QE gradually.**

Andrew Lilico said that the argument is not so much why we should raise rates now but why we should keep them unchanged. The economy is showing every sign of being strong enough to bear a rate rise. It is unhealthy for the economy to be so far from a natural rate for the economy. There is always an excuse for not raising rates but even Brexit is not a good enough reason for not raising rates. He said that QE should be reversed to raise 10-year bond rates to match inflation.

### **Policy response**

1. On a vote of 6 to 3, the committee agreed to keep Base rate unchanged.
2. Brexit concerns and, to some extent, the weakness in monetary growth were the main reasons for the recommendation of holding rates.
3. There was a consensus for a bias to raise Base rate once the Brexit uncertainties were out of the way.
4. The three members that voted to raise Base rate recommended a raise of 25 bps.

## **Date of next meeting**

15<sup>th</sup> January 2019.

## **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 of 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.

### **Current SMPC membership**

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Rotating Chairmen are Andrew Lilico (Europe Economics) and Trevor Williams (University of Derby). Other members of the Committee include: Philip Booth (St Mary's University, Twickenham), Roger Bootle (Capital Economics Ltd), Juan Castaneda (International Monetary Research and University of Buckingham), Jamie Dannhauser (Ruffers), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Julian Jessop (IEA), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Manchester University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School).