

Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes nine / zero to hold Bank Rate in August.

At its most recent face-to-face meeting, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of nine to zero, to hold rates in August.

Members were agreed that in the light of the uncertainty created by the Brexit vote, monetary policy should not be changed in either direction until a clearer picture emerged of the implications for GDP growth and for inflation. A number of members believed that a short-term post-Brexit-vote downturn was plausible, perhaps on top of a slowdown that would have occurred anyway because of global economic factors, but that a better policy response to such a downturn would be additional quantitative easing rather than interest rate cuts.

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 'spares' 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. The next SMPC poll will be released on the Sunday of 11 September 2016.

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Minutes of the meeting of 12 July 2016

Attendance: Jamie Dannhauser, John Greenwood, Andrew Lilico (Chairman), David B Smith, Peter Warburton and Phillip Booth (IEA observer).

Apologies: Roger Bootle, Tim Congdon, Anthony J Evans, Graeme Leach, Kent Matthews (Secretary), Patrick Minford and Mike Wickens.

Chairman's comments

International background

Global credit expansion consistent with moderate growth of world nominal demand

Peter Warburton started his presentation by assessing the state of the world economy and prospective near-term growth. Particular weight was given to recent developments in global money and credit data. He noted that his (GDP-weighted) global credit aggregate continued to imply moderate expansion, with credit growth stable in its recent 5-6% range. While this is below pre-crisis norms, it was viewed as broadly consistent with a reasonable expansion in global nominal demand. The shortfall relative to pre-GFC growth rates was primarily driven by weaker growth in financial corporations' debt; credit provided to the non-financial private sector was expanding at a rate much closer to what was considered healthy before 2007.

Financial conditions, despite Brexit, have eased since the turn of the year

The conversation moved onto an analysis of recent shifts in financial conditions. After Britain's vote to leave the EU, risky asset prices initially suffered but quickly stabilised. While bank equities remained below pre-Brexit levels, it was notable that broad equity indices, corporate credit and government bond prices had all recovered strongly. Looking across the first half of the year, financial conditions had eased, in some countries materially. It was agreed that the combination of lower risk-free interest rates and the fall in risk premia would help support demand in the near-term. Indeed, Peter Warburton noted his expectation that global nominal GDP growth – currently around 4% – was likely to accelerate. A marginal pick-up in global broad money growth, towards 7%, was consistent with this expectation.

'Brexit' shock could delay policy tightening where needed

The discussion then turned to the consequences of Brexit for the global economy. Peter Warburton argued that a disaster scenario had a low probability, a view broadly shared by other members of the SMPC in attendance. While the UK vote would increase corporate and financial market uncertainty, the 'shock' was not viewed as sufficiently serious to alter the core macro view. Peter Warburton did cite concerns about a potential 'capex recession' but did not feel that this would undermine the moderate growth path the world economy appeared to be on.

Global inflation already at 2%; amongst EMs it is elevated and rising

Brexit would have however raised the bar for policy tightening, notably in the US. For how long it was not clear; but with growing concerns about the current asymmetry around monetary policy – able to curb inflation but largely ineffective at boosting demand – the bias was to delay any prospective rate hikes. This was despite the fact that global inflation was not unduly low. Indeed, Peter Warburton's estimates suggested that the (GDP-weighted) world inflation rate was already at 2%. Amongst emerging market economies, where policy rates were generally being lowered, inflation was elevated and on course to rise further.

UK Monetary Situation

Puzzling acceleration of UK bank lending growth

The presentation moved onto the specific macroeconomic conditions facing the UK. Nominal indicators – such as the money and credit data – were analysed first. Peter Warburton initially stressed the acceleration of UK bank lending to the 'real economy' over the last two years. It was noted that credit to 'non-intermediate other financial corporations' (OFCs) – non-bank financial entities – was the main driving force. This was a puzzle since tighter bank regulation post-crisis made bank exposures to the financial sector much more costly in terms of capital. There was no agreement about what might be driving this rise in bank borrowing or its wider implications, although it was noted that in the past rapid growth in bank

lending to OFCs had been indicative of highly accommodative monetary conditions. Analysis by Jamie Dannhauser after the meeting suggested that this lending boom was being driven by a surge in borrowing by UK-resident fund managers. It was agreed that further investigation was warranted, in particular since OFCs' money holdings, which theory suggests should be more closely linked to asset price developments, have been falling of late.

Stamp Duty changes make it difficult to assess lending trends

Bank lending to households and non-financial businesses continued to pick up, albeit at 3½% it was a long way short of the kind of lending growth achieved before the GFC. In the most recent months, momentum in bank lending had waned, although it was unclear what to make of this given the distorting effect on mortgage lending of recent changes to the Stamp Duty Land Tax.

Solid UK broad money growth

Money growth was then considered. As was true at a global level, Peter Warburton noted that underlying monetary trends appeared consistent with decent nominal demand growth. The Bank's preferred measure of broad money growth, M4ex, had ticked up a bit this year (to 4.9% in May). Trends over recent months looked a little stronger, notably within the money balances of UK non-financial businesses.

Consensus expecting 1-3% hit to output from Brexit

The focus then shifted to the immediate consequences of 'Brexit' for UK output. Peter Warburton noted that the consensus seemed to have gravitated to the view that the UK economy would be 1-3% smaller as a result of the vote to leave the EU than it might otherwise have been. Other attendees confirmed that this was indeed the range of values being considered by market analysts.

Fiscal expansion likely to limit post-Brexit fallout

Relative to this consensus view, Peter Warburton made the case for expecting a somewhat smaller drag on output. He argued that the hit to activity would be at the lower end of this range, citing a figure of 1% real GDP in 2017 as his base case. In that baseline scenario, the UK economy would not enter recession, instead suffering a period of sub-par expansion. With growth below the economy's 'speed limit', spare capacity would grow, although it remained uncertain whether this would ultimately leave output below its potential level or not. While he felt that monetary policy would not offer much support to growth, Peter Warburton highlighted the possible, even probable, shift in UK fiscal policy. With the current plans (of a 1% per annum structural budget tightening) ditched, the possibility of overt fiscal expansion was raised.

Gaping current account deficit a key financial stability risk

After outlining his core view on growth, Peter Warburton turned to the risks to the outlook. Beyond the obvious possibility that the near-term hit to growth from 'Brexit' would be larger than expected, the gaping current account deficit was put forward as a key threat. As also noted by the Bank of England's Financial Policy Committee, the weak current account position was viewed as a notable financial stability risk.

Sterling's collapse should help close the current account deficit

Historically, large current account deficits had preceded financial and banking crises. In Britain's case, it was now running at 5½% of GDP (2015 data), the largest peace-time deficit since records began at the start of the 19th century. However, it was stressed that this did not reflect a deteriorating trade balance and as such an obvious worsening of the UK's competitive position. In addition, it was noted that Britain's exit from the EU would incentivise the government to make the economy an even more attractive place for foreign capital to invest in. Peter Warburton remained confident that FDI inflows would continue in spite of 'Brexit', going a long way towards 'financing' the large current account deficit. It was also mentioned that the large post-Brexit fall in sterling would bolster net exports and UK firms' investment income earned abroad.

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

Discussion

Uncertainty around near-term growth path very high

Attendees then discussed the material that Peter Warburton had presented. There was an initial discussion about the near-term output effects of Brexit. It was felt that the consensus view about the likely hit to UK output was in the right ballpark. Some members agreed with Peter Warburton's argument that the economic damage would be somewhat less material but this view was not universally held. All agreed, however, that uncertainty around the near-term path for the economy was considerable.

Lack of information a real policy constraint

With this in mind, it was unclear when sufficient information would become available to gauge the lasting hit to demand, potential supply and inflation. Early readings on business confidence from surveys, it was felt, were unlikely to provide a decent read on the state of the economy.

Concern that BoE governor had pre-judged rate decision

It was, therefore, worrying to most, if not all attendees, that the Bank of England governor had already pre-judged the outcome of upcoming MPC meetings by calling for additional monetary ease over the summer. [In the week following the Shadow MPC meeting, the Bank's Chief Economist, Andy Haldane, took a similar position with respect to the August meeting, arguing for a monetary response "to be delivered promptly as well as muscularly".] Attendees discussed the desirability of publishing an open letter calling on the MPC to avoid a rushed, ill-informed policy intervention. It was agreed that Jamie Dannhauser would draft a letter. [A letter signed by all SMPC members was published in The Times on Thursday 14th July, the morning of the July MPC meeting.]

Would a Bank Rate cut help?

The discussion then turned to the potential monetary response if the economy weakened sharply. Andrew Lilico, the Chairman, asked why the MPC was considering a cut in Bank Rate to below 0.5%, when it had previously ruled out such a step. If it was felt counter-productive previously, why would a further reduction in Bank Rate help to bolster demand and inflation now?

Malign side-effects from further monetary easing?

Peter Warburton responded that such a move would predominantly exert its effect on financial conditions and the economy via the 'signalling' channel, i.e., it would demonstrate to markets and economic agents that the Bank of England would cushion any slowdown/downturn. He, and others, however questioned whether this would in fact offer much in the way of demand support. As had been true in past SMPC meeting, attendees also raised the dangers of persistently low interest rates and the collateral damage that easy money policies might cause.

QE a better approach than Bank Rate cuts

John Greenwood argued that Bank of England purchases of UK government gilts ('quantitative easing') was the preferred course in a situation where the SMPC felt additional stimulus was needed. The aim would be to bolster broad money directly – ideally by buying securities from the non-bank domestic private sector – rather than using lower interest rates to stimulate additional bank lending, indirectly boosting the amount of money in circulation.

Pre-announce QE programme but no move yet...

Given that the UK private sector still had an overhang of debt, John Greenwood felt it was unlikely that a fall in Bank Rate would stimulate additional borrowing, but if it did it would only add to the economy's deep-seated vulnerabilities. In light of the lack of information about the state of the economy post-Brexit and the risk of a fall in the rate of money growth, he made the case that the right approach was to obtain authorisation for and announce another QE programme but to leave the scale and timing of purchases contingent upon the flow of data. Policy, he stressed, should be highly data dependent at this stage.

Limits to monetary policy

Philip Booth then argued that monetary policy cannot deal with real phenomena. He cited the examples of Japan in the 1990s and the Eurozone today as economies where too much weight was placed on the shoulders of monetary policy to the detriment of policies that would improve the economy's supply potential. Attendees generally shared these sentiments.

Monetary policy might undermine necessary resource re-allocation

'Brexit' may have lasting supply-side consequences. While there was disagreement about the scale and sign of the long-term effect on UK potential output, all agreed that 'Brexit' would require a meaningful re-allocation of labour and capital resources within the economy. Monetary policy was ill-equipped to speed up this process and could potentially undermine it, especially if the upswing in inflation from Sterling's sharp fall was allowed to become embedded in the price-wage setting process. Broadly speaking, SMPC members were more concerned about the upside risks to inflation over the medium-term (due to higher imported costs) than recent speeches suggested the actual MPC was likely to be.

Sterling's depreciation might boost inflation

David B Smith commented that in his macro-econometric model the recent Sterling fall lifted CPI inflation to 2.3% by the final quarter of next year (above the Bank of England's target). While it also revealed a positive tailwind through higher net trade, he challenged the argument made by some that the currency's depreciation meant a big impulse for the economy that would offset any increase in precautionary saving by households and firms. He stressed that central bank macro models generally failed to provide reasonable forecasts of the economy because they systematically excluded banking sector flows, in particular money balances and their aggregate demand effects. Following up on Philip Booth's earlier point, David B Smith also challenged the emerging view on the MPC that 'Brexit' represented a clear-cut "demand shock". Because the longer-run damage to Britain's supply capacity was unclear, it was dangerous for policy to move forward on the basis that this clearly represented a 'shock' to aggregate spending. Whether Brexit eventually proved to be benign, or harmful, depended on the policies pursued afterwards. Making a success of Brexit required numerous microeconomic adjustments – i.e., maximising supply side flexibility. David believed that policymakers should now do everything possible to improve the supply side by de-regulation and tax simplification and reform. It was dangerous for policy to move forward on the basis that Brexit represented a pure Keynesian 'shock' to aggregate spending that could be alleviated by even further fiscal laxity.

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

Votes¹

**Vote by Philip Booth
(Cass Business School)**

Vote: Hold Bank Rate

Bias: To raise if sterling weakens further

Philip Booth shared John Greenwood's views about the relative merits of QE versus cuts in Bank Rate. Were money growth to fall sharply, and indeed decline outright, he would support another round of Bank of England gilt purchases, but this was not in his baseline scenario. He viewed it as more likely that Bank Rate would need to rise. Were Sterling to fall further, he felt Bank Rates hikes would be needed to bring inflation back to 2% over the medium-term.

**Vote by Jamie Dannhauser
(Ruffer LLP)**

Vote: Hold Bank Rate

Bias: Neutral

Having previously voted to hike Bank Rate, Jamie Dannhauser now felt that policy should remain on hold. He stressed that an aggressive, pre-emptive move to ease policy was unwise. It was entirely justified for both the MPC and FPC to stand ready to provide support – monetary and macroprudential – in the case of a sharp, severe downturn in activity. But this was not what model estimates suggested was likely post-Brexit.

¹ Note that although the meeting was held before the July MPC meeting and vote, the votes recorded relate to the August MPC decision.

Little was yet known about the near-term economic consequences, in particular how far demand might fall below the now lower path for potential supply. What was known, however, was the likely impact of sterling's slide on imported goods prices. Recent Bank of England analysis estimating the pass-through to CPI inflation suggested a boost to the level of consumer prices of 3% or so over the next 2-3 years. As such, CPI inflation was set to rise above the 2% target, potentially moving above 3% in 2017. With the economy already very close to full employment, he felt it important that monetary policy move cautiously. It looked increasingly likely that the UK would pursue a materially less restrictive fiscal path from here. Outright fiscal expansion may even be on the way.

He was comfortable supporting additional monetary expansion if it became clear that the UK economy was entering recession. But this would not be known for some months. There was a danger of over-reacting to an "uncertainty shock" while ignoring the much more certain impact on inflation through 2017/18. In contrast to just before the GFC, it is far less obvious that monetary policy can 'look through' the price level effect from the fall in sterling.

**Vote by John Greenwood
(Invesco)**

Vote: Hold Bank Rate

Bias: Authorise QE but no purchases until data confirms downturn

John Greenwood thought M4x growth at 4.8% year-on-year in May was adequate, but that the Brexit shock could cause a temporary "credit freeze" or a slowdown in credit and money growth. To avoid such a squeeze he advocated a new tranche of QE purchases to be authorised and announced, but held over until the data-flow confirmed the need for it. Given that borrowing was currently minimal at a Bank Rate of 0.5%, a reduction to 0.25% or lower was unlikely to raise the demand for loans, and in any case creating new money directly via asset purchases from non-banks – if warranted -- would be desirable since it would increase M4x without increasing private sector leverage.

**Vote by Andrew Lilico
(Europe Economics)**

Vote: Hold Bank Rate

Bias: To raise

Andrew felt there was a case for challenging current market speculation about Sterling's fair value. This meant policy should not be set on the basis of what markets expected the MPC to do. He felt it was important for the MPC to signal clearly its intentions. As was true of other members, he argued it would be a serious error for the MPC to make policy on the basis of what were effectively guesses about the state of the economy. He challenged the pre-Brexit consensus that leaving the EU would do long-term harm to the economy. He went further though, arguing that it was even more unsatisfactory that UK monetary policy was being set on the basis of such views. He remained eager for Britain to return to a path of gradually rising policy rates.

**Vote by David B Smith
(Beacon Economic Forecasting)**

Vote: Hold

Bias: Stand ready to provide additional QE if needed

David B Smith suggested that there was a fundamental methodological difference between those who regarded the economy as being akin to a mechanical system, albeit one constantly battered by 'noise', and those who thought that everything was psychologically determined, so that the economy could suddenly leap from one state to another as expectations shifted. This distinction broadly

corresponded to that between those who thought that Brexit could be managed relatively painlessly, provided that the correct policies were pursued afterwards, and the 'we are all doomed' school, who thought that Brexit would provide such a psychological trauma that the economy would nosedive into recession.

As a macroeconomic modeller, David added that generally he was of the first persuasion. He then added that Ronald Reagan's "don't just do something, stand there" was probably the best policy advice. He then cited the results from the latest iteration of his Beacon Economic Forecasting Model. It projected output growth of 1.7%, 2.2% and 1.9% in 2016, 2017 and 2018 respectively. These were post-Brexit numbers and incorporated the current reduced level of sterling, which he regarded as one of the main 'transmission mechanisms' arising from Brexit. However, previous sharp sterling falls tended to show that around half of the depreciation in one quarter was clawed back in the subsequent one. He would not be surprised if this happened again, particularly given the potential political uncertainty generated by the forthcoming elections in France and Germany in the next few years. He felt that the monetary background was reasonable. In particular, the 4.9% annual growth in M4ex in May represented an increase of almost 4.5% in real broad money balances; such a figure should support an expansion in real home demand in the 2% to 2.5% range. He supported John Greenwood's argument that a cut in Bank Rate from its present low level would be unsuccessful in stimulating the economy. Were monetary expansion to be needed, he favoured additional QE. But he stressed the danger that the announcement of stimulus at this point in time would be counterproductive, convincing economic agents of the downturn that policymakers hoped to avoid. To the extent that fiscal expansion was in the pipeline, these concerns would be magnified. While noting the potential short-term boost, he argued that given the poor initial fiscal position – a large deficit and high public sector stock – the effect on growth would likely be negative, citing traditional Ricardian concerns about how the private sector would respond.

He stressed that Brexit would require major supply-side adjustment and that any resource re-allocation could prove to be a very difficult process. While there may be long-term benefits from Brexit, it would require concerted government efforts to de-regulate the economy further. In light of the necessary supply-side shift, he worried that the likely crack-down on immigration would be damaging, constraining the supply of labour at a time when higher imported inflation would incentivise existing workers to push for higher wages.

On a personal note, David announced that this meeting would be his last attendance at SMPC after 19 years as a member and wished the committee well. He added that the low intellectual quality of the Brexit debate had again emphasised the importance of independent economic commentary from bodies such as the SMPC, which had no political axes to grind.

Vote by Peter Warburton
(Economic Perspectives Ltd)
Vote: Hold Bank Rate
Bias: to raise

Notwithstanding potentially softer economic data in the near-term, Peter worried that inflation could gain traction in the economy over the next couple of years given the big fall in Sterling. As was true of other members, he felt comfortable supporting additional asset purchases if the economy tanked; but not if the economy simply entered a period of softer growth. His bias was to hike rates once the immediate shock of Brexit had passed. In discussing a new QE programme, Peter argued for purchases of corporate debt, not gilts, given how far risk-free interest rates had already fallen and the dangers of flattening the yield curve even further, e.g. for bank profitability. Indeed, he favoured the Bank selling some of its existing gilt holdings to purchase an equivalent amount of sterling corporate debt.

Additional votes from members unable to attend the meeting

Vote by Timothy Congdon

(University of Buckingham)

Vote: Hold Bank Rate; no additional QE

Bias: None

No change to interest rates or QE. Brexit seems to have had some effect on transaction levels in the property market, from those influenced by negative press coverage. But that should be expected to wash out in the next few weeks/months.

Vote by Kent Matthews

(University of Cardiff)

Vote: Hold Bank Rate

Bias: None

Monetary policy should remain unchanged for now until a clearer picture of the inflationary consequences of the depreciation of sterling emerges.

Vote by Trevor Williams

(University of Derby)

Vote: Hold Bank Rate

Bias: To ease

The UK economy was slowing before the referendum result on the 23 June to leave the EU after 43 years. The uncertainty generated by this result will likely cause the economy to slow in the next few quarters. But any policy response – whether fiscal or monetary - should depend on how severe this slowdown is shaping up to be.

Short-term economic indicators so far – and there are not that many – have been suggesting that the economy has coped well to date. But that might be about to change, at least according to the Purchasing Managers' Indices for June. The sharp fall in the services PMI in particular looks worrying, as services account for 80% of output in the economy. The shock to the economy could be more severe than the average of other indicators so far have suggested. If the current levels of the construction, manufacturing and services PMIs are maintained, that will provoke a policy response from the Monetary Policy Committee (MPC).

For that reason, to get more 'bang for the buck of easing policy' I would hold Bank rate until it is clearer what is happening to the economy, and what the fiscal response is likely to be from the Chancellor of the Exchequer, Phillip Hammond.

But with productivity likely to be hit by a slowdown in investment spending and employment growth to ease back even further than recent trends have suggested, there should be an appreciable drag on the level of economic activity in the next few quarters.

The challenge or dilemma is easing policy at a time that a 13% fall in sterling versus the dollar is likely to lead to a shift up in the price level, though not the rate of expected inflation. Will the MPC, as widely expected 'look through' the spike in prices, and set policy for the weakening real economy in the medium term, just as it did in the aftermath of the global financial crisis in 2008?

Policy response

1. On a vote of nine to zero, the Committee voted to hold Bank Rate.

Date of next vote release

Sunday, 11th September 2016

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