Shadow Monetary Policy Committee

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Shadow Monetary Policy Committee votes Six / Three to Raise Bank Rate in December.

In its December 2016 e-mail poll, the Shadow Monetary Policy Committee (SMPC) elected, by a vote of Six to Three, to raise rates in December.

Advocates of rate rises noted the rapid growth in the broad money stock in the year to September 2016. Two contended that this can be seen as heralding the end of the 2008 crisis, with one of these (Greenwood) making his first vote to raise rates since 2008. Others noted that the depreciation of sterling in recent months (albeit partially reversed since mid-October) provides the Bank of England with an opportunity to raise rates. One asked: “If not now, when?”

Those advocating a hold noted that although monetary growth has been rapid, credit growth has not, and felt that it would be better to wait before raising to reflect upon the impact of the triggering of Article 50. All three of those advocating a hold at this stage expressed a bias to raise in forthcoming months.

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. The next SMPC poll will be released on Sunday 29th January 2017.

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Votes

Vote by Philip Booth

(St. Mary's University, Twickenham)
Vote: Raise Bank Rate to 1%
Bias: Neutral

Vote by Tim Congdon

(University of Buckingham)
Vote: Hold Bank Rate
Bias: Raise

The M4x measure of broad money grew by 7.8% in the year to October, clearly much too fast a rate to be consistent with the 2% inflation target in the long run. A fair generalisation is that the annual rate of broad money growth should not be much above 5% if the 2% inflation target is to be met. Not surprisingly, the pound has weakened and inflation will be higher in 2017 than in 2016. (Yes, the 23 June Brexit referendum has taken the blame, but ultimately any exchange rate is a price determined by supply and demand. What matters here is the quantity of money expressed in a particular currency relative to the demand to hold that particular currency. Switzerland has never been a member of the EU, but that has not stopped the appreciation of the Swiss franc.)

Money growth over the last year has been above the increase in bank credit to the private sector. M4xL (i.e., bank lending excluding intermediate other financial corporations) went up by 6.1% in the year to October. The difference between the increases in money and credit reflects, to a significant extent, recent purchases of government securities under the QE exercise announced on 4 August. (In the year to July the public sector contribution to money growth was trivial, adding a mere £0.4b. to M4. By contrast, in the three months to October the public sector contribution to money growth was positive by no less than £39.0b. The public sector contribution to money growth is the most direct measure of QE operations.)

The latest QE purchases are misjudged and should be halted immediately. Given the pound's weakness, I would be in favour of a 25 basis point rise in Bank rate if credit growth were moderate and of a 50 bps rise if it were rapid. But in recent months the growth of M4xL has been slowing, perhaps because the banks are still restricting balance-sheet growth to meet stress tests and other regulatory restrictions. So I am in favour of no change in Bank rate, but with a bias to raise.

Vote by John Greenwood

(Invesco Asset Management)
Vote: Raise rates to 0.5%; suspend asset purchases, but hold in reserve.
Bias: None.

It is now clear that the decisions taken by the MPC in August to cut Bank rate to 0.25%, to add £60 billion of asset purchases (QE) and to introduce a new Term Funding Scheme were unwarranted. Money (M4x) and credit growth have accelerated sharply to 7-8%, roughly doubling their growth rates, and consumer spending has far exceeded most forecasts in the months since the vote on June 23 to exit the EU. Given the steep falls in sterling since the Brexit vote, there is a clear danger that – if current money and credit growth rates are allowed to continue – domestically generated inflation will be added to imported inflation in 2017-18.

In July this Shadow MPC had met to discuss the appropriate measures, and it was proposed that "In light of the lack of information about the state of the economy post-Brexit, […] the right approach was to announce another QE programme but to leave the scale and timing of purchases contingent upon the flow of data." That remains the correct action to have taken because it may yet be the case in 2017 that investment spending falls and the real value of consumer spending weakens abruptly as consumer prices rise ahead of wages, in which case some additional stimulus may be needed. However, we simply cannot know, and therefore it would have been better to have held back from action in August.

Nevertheless, as far as 2016 is concerned, money and credit growth have been accelerating since April, implying excessive expansion over at least six months. Fortunately, the die is not yet cast, and the situation could still be brought back under control, but every month that passes will enhance the risks of higher than target inflation in the year ahead. This is why it would be appropriate to reverse the August rate cut and suspend gilt and corporate bond purchases under the APF (Asset Purchase Facility).

The interesting question is why, in the face of all the uncertainties of the past six months, British banks have suddenly sprung back to life, expanding lending and causing the deposit component of M4x to accelerate so quickly?

The answer is that banks have largely completed their balance sheet repair work, which means that they are no longer so constrained by capital requirements or by their dependence on interbank funding. The stress test results announced by the Bank on 30th November showed that while "some capital inadequacies were revealed for three banks (The Royal Bank of Scotland Group, Barclays and Standard Chartered), these banks now have plans in place to build further resilience. The Financial Policy Committee (FPC) judged that, as a consequence of the stress test, the banking system is in aggregate capitalised to support the real economy in a severe, broad and synchronised stress scenario".

With respect to funding sources, it should be recalled that at the peak of the crisis in 2008, British banks were in the incredible position of funding no less than £756 billion of lending, equal to 50% of GDP, from interbank, capital market, or non-deposit sources. (As an aside, permitting this to happen, alongside allowing bank capital levels to fall so low, constitutes a serious indictment of UK regulators and their methodology at the time. The evaporation of these non-deposit sources was the direct cause of the capital market freeze that did so much to intensify the recession.) However, since the start of 2016, UK banks have at last moved to a position where they have run down those interbank borrowings and are no longer dependent on interbank or non-deposit sources of funds for lending. These two factors explain the sudden return of "animal spirits" among the banks during 2016. It is now incumbent upon the MPC and the FPC to get things back under control.

Vote by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate; Hold QE
Bias: Bias to increase interest rates; no bias for QE

Vote by Andrew Lilico

(Europe Economics)
Vote: Raise 0.25%
Bias: to Raise by 0.25% each month until rates reach 2%

Annual broad money growth (on the M4ex definition) is running at over 7.5%. This is a level that was common between 1998 and 2005, but to which broad money growth never remotely neared between mid-2008 and 2016. There is a reasonable chance that history will record that the monetary aspect of the Great Recession ended in the UK in the third quarter of 2016.

GDP growth is solid, with no evidence of any material slowdown following the EU Referendum result. If GDP had actually been going to be around 6% lower by 2030, as per the economic models of the long-term impact of Brexit done by the Treasury and the OECD, we would have expected forwards-looking consumption-smoothing households to have cut their consumption immediately after the vote, by something of the order of 3-5%. The absence of any such response by consumers is so stark that it is increasingly clear that consumer expectations embedded in economic activity include no material change, either way, in the outlook for UK GDP by 2030.

Sterling has strengthened in recent weeks, with its trade-weighted level up around 6% from its October lows. That puts the trade-weighted effective exchange rate back to levels that were typical in 2009-2011 and again in 2013. Even with that rise, however, sterling is still markedly down from its November 2015 peak and inflation is projected to over-shoot the 2% target.

With money supply growth rapid, GDP growth solid and inflation set to overshoot its target, whilst sterling remains weak, what is the rationale supposed to be for emergency levels of interest rates of 0.25%? If this scenario does not justify rate rises, what would? Must we wait until inflation actually goes back to 5%? Would even 5% be enough this time, given that it was not enough in 2011? The Bank has consistently missed opportunity after opportunity to raise rates since mid-2011, and now finds itself wondering aloud why productivity growth is poor. How could there *not* be a connection between interest rates being held at zero for eight years and productivity growth being poor? What did the Bank expect?

Vote by Patrick Minford
(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by 0.25%, end QE
Bias: to Raise
So much political capital has been sunk into the centralising European Project that it has always seemed most unlikely that it could be stopped or derailed sufficiently to make it change its nature fundamentally. M. Delors sent it off in the late 1980s on that mission of centralisation: the Social Market with a Uniform Regulative System policed by Qualified Majority Voting (so making member state objections generally futile), followed by the setting up of the euro in the Maastricht Treaty, and finally solidified into place by the Lisbon (Constitutional) Treaty. The whole process has been breath-taking in its audacity. Proud nation-states have been turned into vassals by a machinery that has simply rolled on, partly by trickery, partly by inertia, in the creation of a new European Empire, ruled by a neo-Hapsburg civil elite.

Often on this side of the Channel British commentators used to democratic checks and balances, and popular jettisoning of failing economic policies have said that the euro ‘would collapse’ or that the EU would have to abandon its centralising dream. But they have underestimated the sheer dogged perseverance of that elite and the timidity of the people of the different nation-states when faced with the question of departure from either the euro or the EU’s direction.

However, so bad has been the experience of countries to the south of Europe, including both France and Italy, both economically with unemployment rising threateningly again and with the migration and terrorism crisis, that things are changing. Brexit, the election of Trump as US President, the Renzi referendum No, the upcoming French Presidential elections with Marine Le Pen looking strong, and perhaps even after that a threat to Angela Merkel from disappointed supporters on the German right; all these events look like a new political environment. The first casualty could be the euro-zone which has failed southern Europe, creating misery on an epic scale. It may well shrink back to a core of northern states that do not need fiscal union to coexist inside a monetary union. Elsewhere the old currencies will start to reappear.

Following that will come proper borders inside the EU and possibly the abandonment of free movement of labour, always a doubtful economic component of the Single Market where trade is sufficient to achieve efficient resource allocation.

Finally we will surely see increasingly more competition in tax and regulation, as nation states get back regulative powers and the Single Market gradually defaults to the original idea of competing regulative systems under mutual recognition.

These changes will again preoccupy the EU and will make the Brexit negotiations with the UK less hostile, since ironically the UK wants a relationship of friendly cooperation in a sea of other countries which are increasingly unfriendly to the EU. When one adds to this the Trump plans for more disengagement from Europe, the implication is that Eastern Europe will be much more inclined than before to accept UK demands for migration control, since the UK is now a key guarantor of NATO's eastern borders.

Where will this push the UK outlook? I already saw this as promising stronger growth. With a more cooperative Brexit that outlook improves. With the euro in more and more trouble sterling will continue to recover from its post-Brexit shock fall. We have suggested that the necessary fall in sterling's effective rate by 2020 was more like 6% than the 16% or so of recent weeks. It is likely to move back up over the next few years.

One of the accompaniments of Brexit is more freedom to reform the clunky UK tax system, side by side with the freedom to improve the inherited top-down Brussels regulative system. We are now discovering in field after field how restrictive that system was- whether in medicines, in finance or industrial standards. Taken with tax reform, the market environment in the UK is likely to be entering a golden era.

With growth strong and stimulated by the large fall in sterling- a massive unscheduled monetary stimulus- monetary policy needs to tighten. QE should be reversed and interest rates raised, both in a gradual manner.

Unfortunately both the Bank and the Treasury/OBR have not caught up with this outlook. They are still mired in pre-referendum fallacies about 'uncertainty' and long-term Brexit 'damage'. Official forecasts, and with them too many private forecasts, will take time to adjust to the truth about Brexit and the manifest absence of 'uncertainty damage'- the only uncertainty in UK policy is the extent to which Brexit will be dominated by world free trade rather than the 'soft Brexit' status quo option, viz the extent of the upside, hardly a damaging sort of uncertainty!

Can this 'official downbeat' attitude actually damage confidence? No, because we can assume that people and firms in the market place will judge the outlook rationally. Already we see that business confidence is strong, with manufacturing investment intentions, that official s thought would be dampened, strongly positive in the latest CBI survey.

With Trump's proposed infrastructure, tax cut and deregulation programme boosting the US economy, joining the UK's better growth prospects post-Brexit reforms. This is a good time to hold and buy equities and to dump over-priced bonds.

My vote is therefore to raise interest rates forthwith by 0.25% and thereafter gradually; and reduce QE also gradually — I suggest by around £35 billion per quarter, so that the Bank would have liquidated all its holdings within around three years.

Vote by Peter Warburton
(Economic Perspectives Ltd)
Vote: Raise Bank Rate by 0.25%; Reallocate £50bn of QE from gilts to infrastructure bonds.
Bias: to Raise Bank Rate in stages to 1.5%.
The latest batch of UK monetary statistics should remove all doubt concerning the appropriateness of a rise in interest rates, initially to restore the ill-conceived August Bank Rate cut, and then to press ahead towards an interim target of 1.5%. On the expectation of CPI inflation of around 2.5% in calendar 2017, this would still represent a negative real interest rate.

The preferred broad money supply measure, M4ex, has gathered momentum this year, for an annual rate pushing 8%; the analogous M4 lending stock is rattling along at more than 6%. There may be a little consternation that non-intermediate other financial corporations have been the strongest component of the credit and monetary acceleration, but the UK has a sizeable financial services sector which has a justifiable demand for credit and liquidity.

Loans to construction, real estate, distribution, hotels and restaurants are running much faster than a year ago. Mortgage debt is increasing at a steady 3% annual pace, which non-mortgage consumer debt is powering along at 10% a year, fuelled by consumer auto finance plans in particular. Loans to non-financial corporates and corporate use of capital market credit are both buoyant.

The hesitancy of the Bank's MPC is bewildering: courtesy of Brexit, a new opportunity has presented for the committee to switch to a tightening tack. The combination of monetary acceleration, booming retail sales and rising employment invites is an invitation to the Bank to demonstrate its credentials. Moreover, the Autumn Statement provides an element of fiscal cover for ever-so-slightly higher interest rates. If not now, when?

Vote by Mike Wickens
(University of York)
Vote: raise bank rate by 0.25% and start to decrease QE
Bias: start to unwind QE and slowly raise interest rates as the economy grows
The MPC were wrong to loosen monetary policy further in August. With the uncertainties facing the UK economy lessening and growth and inflation picking up this is a good time to begin removing the distortions to financial markets.

The MPC seem not to understand the effect that lowering the interest rate differential has in the short run on the exchange rate. When several years ago the Bank published a paper outlining four channels by which monetary policy is transmitted to the economy they put the exchange rate channel last. In experiments I performed with the Bank's then current model I found that 80% of the effect in the first year came via the exchange rate. But this all but disappeared after 2 years. Not surprisingly, therefore, the August cut in rates had a similarly strong effect.

Having failed in its use of QE to return inflation to target, did the Bank really intend to use the exchange rate to do this, or was it just another example of the Bank's focus on aspects of the economy that are not part of its remit?

Vote by Trevor Williams
(University of Derby)
Vote: Hold Bank Rate
Bias: Raise rates 0.25% to 0.5%
UK economic growth was 0.5% in Q3, down from 0.7% in the previous quarter but 2.3% higher than the same period of the year before. Trends in the underlying data suggest that Q4 2016 should see growth of around 0.5% as well. Annual average economic growth so far in 2016 has been 2.1%, in line with the long-run trend.

Of course, there are big differences in detail: within the growth of 0.5 in GDP during Q3, services grew 0.8% but total production fell by 0.9%, and construction output dropped by 0.6%. Since services account for 79% of the output measure of GDP, the overall rate of growth of the whole economy was, therefore, stable.

Retail sales volume growth in the quarter to September was up 1.9% on the previous quarter, the 34th three-month period that this has occurred. Business investment also grew, up by 0.9% in Q3.

The solid pace of economic growth has led to a fall in the unemployment rate, to 4.8% in the three months to September, the lowest since July - September 2005. At the same time, total pay growth has not accelerated, and was at an annual rate of 2.3% in the three months to September, the same as a year ago. Consumer price inflation in October rose 0.9% on the year before, and though the fall in the pound's value will push up the price level in the next 18 moths, it is not clear that this will be inflationary.

Growth in the monetary statistics supports at least a trend pace of expansion in GDP in the period ahead. Total M4ex was up 7.8% in the year to October (the 3-month rate decelerated to 6.9% from 10.1% in September), with lending growth up by 6.1%. Borrowing by individuals as a whole was slower at a 4% annual pace, about the same as in the last three months. Mortgage borrowing was up by 3.1% on the prior year, and consumer credit growth increased by 10.5%. Within consumer credit, credit card borrowing grew 9.0% on the year, but overdrafts and other personal loans were up by 11.4%.

In short, economic data since the referendum have been fairly robust. This suggests that there was no need for monetary easing from the Monetary Policy Committee (MPC) in August although we do not know what would have happened had easing not occurred.

On that basis, I would vote to end QE but leave Bank rate on hold, for now, to see if the economy weakens as we enter 2017, and trigger article 50. If economic growth does not slow appreciably in Q1 2017, a 0.25% rise to 0.5% to reverse the cut in August would be warranted. In my view, the rate environment has been correct over the last few years, as it has maximised growth and employment without jeopardising the inflation target.

Policy response

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

2. One member voted for an increase of 0.75%. All other members favouring a rise voted for an increase of 0.25%.

Date of next poll

Sunday, 29th January 2017

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