

Shadow Monetary Policy Committee

14th January 2020

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The Shadow Monetary Policy Committee votes six / three to Hold Bank Rate in January 2020.

In January 2020, the Shadow Monetary Policy Committee (SMPC) voted by six votes to three to keep Bank rate at 0.75%. But six of those who voted had a bias to raise rates in the next few months.

The majority view to keep rates at 0.75% was based on signs that the UK economy faltered towards the end of 2019. Despite some more recent data suggesting that the economy could pick up in early 2020, the majority opinion was to wait and see whether the acceleration materialised. Concern persisted about high levels of uncertainty, partly related to the departure of the UK from the EU on 31st January and the subsequent effects on business confidence of the ebb and flow of negotiations about a free trade agreement (FTA).

A further complication is the UK Budget, the first for Chancellor Sajid Javid, set for 11th March, which is widely expected to see some significant fiscal easing. However, it may be wise to know the extent of that fiscal loosening before reacting by raising rates. Therefore, the majority voted to keep rates on hold.

The three dissenting members thought that there should be no further delay and rates should be increased by ¼% to 1%. One argument is that the UK's labour market data show that the economy is at full employment, as reflected in rising real pay. Taken with the removal of political uncertainty following the General Election, and of uncertainty about the timing of Brexit, they feel a rate increase is warranted. Furthermore, two dissenters argued that a rate rise is justified because rates had been too low for too long, promoting unproductive investment and resulting in low productivity and weak growth.

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.

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Minutes of the meeting of 14 January 2020

Attendance: Phillip Booth, Juan Castaneda, Julian Jessop, Andrew Lilico, Kent Matthews (Secretary), Peter Warburton, Trevor Williams (Chair).

Apologies: Tim Congdon, Jamie Dannhauser, John Greenwood, Patrick Minford, Roger Bootle

Chairman's comments: Trevor Williams said that he did not have any announcements to make.

Peter Warburton drew the attention of the committee to a reference to the SMPC in a speech, 'A Framework for All Seasons' by Mark Carney delivered on 9 January 2020. In defending the MPC's decision to depart from its historic reaction function in 2013-14, Carney references the SMPC among external commentators who argued the opposite case, voting for higher interest rates at all fourteen meetings between November 2013 and December 2014.

Trevor Williams invited Julian Jessop to present his economic report.

The Global Backdrop

Julian Jessop said that he would begin with the global backdrop, present the latest UK indicators and discuss some Brexit scenarios. He said that there was a need to discuss fiscal policy and its implication for interest rates, and to take into account market expectations before finishing with his conclusions.

World economy stabilising...concerns of global recession overdone.

Starting with the global backdrop, he said that there are tentative signs that the global slowdown is coming to an end. Various indicators support this but his favourite is the Global Composite PMI that indicates global growth has stabilised at the end of 2019. The latest figures show an uptick in global growth heading back toward 2%. This picture is broadly spread. The eurozone is still relatively weak but there also signs of stabilisation if not a pickup. He said that there was nothing in the data that suggested a strong recovery in 2020 but that concerns of a global recession in the beginning of 2020 look overdone.

Money supply figures ...recession risk pushed back to 2021

He said that fans of broad monetary aggregates will note that US M3 growth has been soaring. Since private credit has not increased to the same extent, this represents the monetisation of government debt. Trevor Williams wondered whether some of this was due to the \$1trln net of tax cuts, which has not been financed by cuts to public spending and so is an effective increase in Government indebtedness that is being financed by the issue of more debt to the private sector. If so, it could prove to be only a temporary boost to money supply. And US growth could still slow into the back end of 2020. Similarly, but not quite as strongly, monetary growth has picked up elsewhere. Eurozone M3 growth has been accelerating over the course of 2019. UK M4x has also been picking up over 2019. Interpreted naively as a recession warning, these figures suggest that recession risk has been pushed back to 2021.

Monthly GDP figures distorted ...PMI figures provide some comfort.

In the UK the real economy data are weaker. UK GDP growth has stalled on the latest figures. Monthly data shows a drop in GDP in November, but this data is unreliable and subsequently heavily revised. It is also possible that the figures indicate a Brexit distortion with activity being brought forward ahead of the latest potential no-deal deadline of 31st October. He said that PMI data provide some comfort. They show that both the UK and the eurozone slowed over the course of 2019, with the final few months showing a levelling out. Andrew Lilico said that there was the reduction in uncertainty and the election effect may also have influenced the figures. Peter Warburton alluded to the exuberance of the latest

(Q4) Deloitte's CFO survey, which reports a rebound in net optimism about corporate financial prospects from -35% to 45% since October.

UK labour market still strong...return of 'Phillips Curve'

The UK labour market continues to provide good numbers. Based on the data in the three months to October, the employment rate is higher than last year; unemployment rate lower; real earnings up 1.5% for total pay and up 1.8% for regular pay, and vacancies although fewer than a year earlier is still relatively high at 794 thousand. Hiring surveys have picked up since the election and there are reasons to be optimistic. Labour market tightness is reflected in the return of the wage inflation 'Phillips Curve' and he referred to the chart on UK and US wage inflation and unemployment on his slides. Juan Castenda warned that the Phillips Curve should not be taken as an interpretation of a causation of inflation. Julian Jessop said that he took the chart as evidence of labour market tightening. Philip Booth said that given stable inflation, changes in nominal wage growth are the same as changes in real wage growth and there is no inconsistency in theory in a real wage growth unemployment trade-off. Julian Jessop said that headline inflation at 1.5% in November, is for now well under control.

Investment stagnant ... Four Brexit scenarios

Julian Jessop said that the big issue going forward is what is going to happen to investment. He referred to the chart of real UK business investment in his presentation which showed that investment has stagnated since the referendum. He said that this is one of the ways Brexit has hit the economy but taking an optimistic view, there is a lot of pent-up demand waiting for greater clarity on Brexit future. Regarding Brexit, he put forward four scenarios. These were, 1) UK Plan A – comprehensive free trade agreement covering all major sectors and allowing for some future regulatory divergence. 2) 'No deal +' – talks breakdown and the transition period concludes at the end of 2020 without a new FTA. 3) EU Plan A – a quick and dirty tariff and quota-free deal, involving stringent level playing field conditions and an agreement on fisheries, deferring other issues until later. 4) Further extension of transition period (even though legislation has been passed to rule this out). He said that plan A is what the UK government is aiming for but the timetable is challenging. Andrew Lilico said that all the 2020 scenarios are about the EU and not allowing for the possibility of a FTA with the USA. He said that 4 scenarios could be USA/EU FTA, USA-FTA/EU-NFTS, USA-NFTA/EU-FTA, USA/EU NFTA. Trevor Williams said that in terms of its economic impact on the UK an FTA with the US could not replace one with the EU, even in its impact on value added.

Plenty of Brexit uncertainty but uncertainty not dominated by Brexit

Julian Jessop acknowledged that his scenarios are overly EU focussed and that there is still plenty of Brexit uncertainty around. He said that over the next couple of years the deal with the EU is going to be important but over the next 5-10 years FTAs with the USA and rest of the world will be more important. Sectoral deals may be easier to do. He added that he would pay most attention to what businesses think. The Deloitte's survey and others show that there has been a big drop off in uncertainty, with Brexit no longer the main concern for many companies. While the Deloitte survey is an outlier other surveys are also positive. The only survey that is a dampener is the Bank of England Decision Maker Panel, which has so far showed only a marginal improvement since the election. Julian

Fiscal Policy

Loose fiscal policy, exchange rates, and interest rate...

Julian Jessop said that a consensus is emerging in favour of looser fiscal policy consistent with an extended period of low to zero interest rates. He added that the BoE may be relaxed about increased infrastructure spending aimed at raising productive potential. He said that he was uncomfortable with this view and questioned whether a substantial fiscal stimulus can sustain low interest rates. Philip Booth said that he was surprised to read that even Patrick Minford appears to be in favour of looser fiscal policy from his recent article in the Telegraph and that this was indistinguishable from Krugman's position. Julian Jessop said that Wren-Lewis and Portes and other have been saying this for some time. Philip Booth said that this argument ignored the exchange rate response to higher borrowing in an open economy with fixed exchange rates. He asked Kent Matthews to explain whether Patrick Minford's proposal would lead to higher

growth in the rational expectations model at Cardiff. Kent Matthews said that while he was unfamiliar with the innovations to the current model, the older RE model would exhibit a multiplier of about 0.5 for a bond-financed fiscal policy and a multiplier greater than unity in the case of a balanced/money financed fiscal policy over a short period. He added that his own view is that loose fiscal policy would be instrumental in getting interest rates rising back to normal levels.

...loose fiscal policy strengthens the case for higher rates.

Julian Jessop said that if there is going to be a fiscal splurge and if you believe that the government is going to make wise investments then, there is an argument for investment for productivity improvement. He said that he was uncomfortable with this argument as government investment would not be as productive and gave HS2 as an example. Juan Castaneda said that we should not conclude that monetary policy is impotent because interest rates are low. There are other tools like unconventional monetary policy. There was a discussion where all members of the committee expressed opinions on the role of fiscal policy in the current state of the business cycle. Andrew Lilico said that the Lucas argument is that rates are low because investment returns are low. Kent Matthews said that the Barro argument of public investment to raise productive potential can still result in a rise in the rate of interest because of partial crowding out. Julian Jessop said that his view was that looser fiscal policy strengthens the case for higher interest rates.

Markets expect an interest rate cut

Julian Jessop said that the markets think it is more likely than not that the next move in UK interest rates will be a cut. Carney's recent comments have helped this view. Juan Castaneda asked whether the BoE would continue with the existing target framework with the new Governor, as the Bank will be reviewing its monetary strategy in 2020. Julian Jessop said that the inflation target framework isn't broken, and he thought that the 2% target would remain the primary focus of the Bank.

To conclude, Julian Jessop said that the UK economy has faltered, and inflation is subdued, but the global backdrop appears to be improving and monetary growth is satisfactory. The labour market remains strong. Brexit uncertainty is still high, but business confidence is beginning to return. Looser fiscal policy could undermine the case for keeping interest rates low. He said that a rate hike now would shock the markets whereas a rate hike in three months would cause less damage to the economy.

Votes are recorded in order they were given

Comment by Julian Jessop

(Independent Economist)

Vote: Hold.

Bias: To raise.

Julian Jessop said that the Bank of England should be thinking of raising interest rates, not cutting them. There was no good reason to shock the markets with a rate hike this month, but he has a bias to tighten and in three months' time there will be more information on the strength of business conditions after the election. The Bank would also have the opportunity to respond to the March Budget. At this point, he expected to be voting again for an increase in rates.

Comment by Phillip Booth

(St Mary's University)

Vote: Hold.

Bias: No bias.

Phillip Booth said that he was not a believer in activism for the sake of it. Inflation is low and there is no indication of an increase. We cannot easily know whether equilibrium interest rates are low because of real factors (e.g. demographics or low returns to capital) and also whether productivity growth was low because of real factors. Theories that suggested that low interest rates were the cause of low growth were speculative and an unconvincing basis for monetary policy.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate $\frac{1}{4}\%$

Bias: To raise

The subliminal message from the deliberations of MPC members is that Brexit is an act of deliberate economic self-harm, justifying urgent medical attention. Industry bodies have reacted with horror at the suggestion the UK may not opt for close regulatory alignment with the EU27, post-exit from the EU. The car industry feels betrayed. The financial services sector is nervous. Surely, their argument runs, the Bank of England should offer cheaper money as an insurance policy against an adverse economic weather event? After all, aren't interest rates falling around the world?

This is not my perspective on the interest rate decision. The UK labour market is tight as a drum: on various metrics, the last time that the employment-unemployment picture was as positive as today was in the early 1970s. The employment rate is at a record high of 76.3 per cent; the unemployment rate at a lowly 3.8 per cent. Real earnings growth is 1.6 per cent on an annual comparison. Self-employment has topped 5 million for the first time. Business confidence measures, such as the Deloitte CFO survey, have rebounded powerfully. The latest Royal Institute of Chartered Surveyors property survey shows a large improvement in its activity and pricing measures. Consumer confidence surveys are expected to jump higher also.

The removal of Corbyn risk and binary Brexit risk is a huge psychological positive, even though Brexit implementation risk remains. It is early in the new parliament when political considerations are at their least significant. The fiscal stance has been relaxed and will likely be loosened further in the 11th March (not-the-Spring) Budget. The UK equity market has risen by over 5 per cent since 11th December. When, in recent memory, has there been a better time to *raise* rates?

He voted to raise by 25 basis points, with bias to raise further.

Comment by Trevor Williams

(University of Derby and TW Consultancy)

Vote: Hold

Bias: No bias.

Trevor Williams said inflation is below target. Admittedly, broad money supply growth M4ex accelerated to 4% in November from 3.5% in October but remains well below a level that implies faster price inflation or GDP growth. Hence, despite

lower unemployment and a tighter labour market, price inflation is likely to remain subdued. Moreover, Brexit will be a negative shock as ease of access to EU markets could be reduced (as it would be in the event of leaving under the terms outlined in the withdrawal agreement at the end of the year). So, a surge in investment is unlikely this year in my view.

Meanwhile, the economy weakened in the final quarter of 2019 and is likely to expand at best by 1 to 1½% or so this year, well below the ten-year average of 1.8% recorded between 2010 and 2019. In turn, this is well below the 50 year average of 2.6%.

In summary, uncertainties remain and given there are no signs of inflation over the horizon, interest rates should remain on hold for now.

Comment by Juan Castaneda

(Institute of International Monetary Research, University of Buckingham)

Vote: Hold

Bias: No bias

Juan Castaneda said inflation is determined by (broad) monetary growth and there are no inflationary pressures from the monetary data. M4X on the latest figures show annual growth of 4% (November 2019). Money growth has been on the rise in recent months but is still quite moderate, and we need to wait and see if the pattern continues in the next few months. This monetary data does not justify a rate rise.

Comment by Andrew Lilico

(Europe Economics)

Vote: To Raise by ¼%

Bias: To Raise.

Andrew Lilico said that his decision to raise rates was based on two positions. The first position on the general view that interest rates should be kept at the lowest level possible just because inflation is under control is the wrong ambition. He is less pessimistic about the world economy and theory to explain low productivity. Keeping interest rates artificially low will undermine long term growth by encouraging low value-added projects before they are liquidated. He said that there was a need for a story as to why low interest rates do not result in more productive investment, but the natural assumption is that there is an equilibrium rate of interest and the correct ambition is to help the economy to move towards it. The second position is about why interest rates should go up now. With the general election, two key sources of uncertainty are removed. First the threat of a Corbyn government is removed and second, we have resolved the Brexit issue of leaving without a deal. We are leaving with at least the Withdrawal Agreement. We may not have an FTA, but a certain Brexit scenario is the WA. Therefore, this is the perfect time for a rise in rates.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: To raise by $\frac{1}{4}\%$

Bias: to raise.

Kent Matthews said that Andrew Lilico had articulated much of what he wanted to say but he wanted to add that he thought that fiscal policy was going to be loose and there is a need to recognise this and pre-empt it by signalling a general rise in interest rates, even if in small steps. The story about low interest rates and low productivity requires a two-sector framework. A high productive sector that is not serviced through conventional credit intermediation and a low productive sector that is. This is an allocative inefficiency which can still be at full employment in terms of the utilisation of resources but has implication for long-term growth. Low interest rates have encouraged a financial repression that has kept the economy in a low productive low growth state. The economy will get back to a higher growth equilibrium only when loanable funds flow away from low-productive sectors to emerging high productive sectors. These are microeconomic issues and a rise in rates will help to mend a broken system and this has nothing to do with the inflation target.

Comment by Jamie Dannhauser (in absentia)

(Ruffer LLP)

Vote: No change

Bias: To lift bank rate gradually

Backward looking UK data has been surprisingly soft. Partly this reflects the global slowdown and idiosyncratic adjustments in critical industrial sectors, notably the auto sector. But there is now a body of evidence that Brexit-related and Corbyn uncertainty has restrained business spending, primarily but not exclusively capital investment. There is a case for responding to this apparent weakness; but in my view it is far from overwhelming. Indeed, the cacophony of MPC voices hinting at an “insurance rate cut” is unhelpful, if sadly predictable. There is a powerful case for waiting to see how the economy will evolve in coming months. While Brexit uncertainties will persist through 2020, the twin tail risks of a no-deal “hard Brexit” and a Corbyn victory are off the table. In fact, Britain now has a stable majority government, with a radical agenda that is broadly pro-market. Early evidence, in particular from the housing market, suggest this reduction in political risk may catalyse a revival in animal spirits and activity more broadly. With the government also about to loosen the fiscal purse strings, potentially dramatically, there is every reason for monetary policymakers to wait-and-see.

Comment by Roger Bootle (in absentia)

(Capital Economics Ltd)

Vote: Hold Bank Rate.

Bias: to tighten

A rise in rates now would shock the markets and the economy. But as evidence mounts of the extent of the Boris bounce and as we experience a boost from fiscal relaxation then the Bank should prepare households and businesses for higher interest rates.

Any other business

None

Policy response

1. Four of the committee who attended voted to keep rates on hold, with one member expressing the position that a rise could occur in three months but not immediately.
2. Three members of the committee voted for an immediate rise by 25 bps.
3. Two votes in absentia were to hold rates.
4. Six votes signalled a bias to raise rates.
5. On a vote of six to three the committee voted to hold interest rates.

Date of next meeting

14 April 2020.

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.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Rotating Chairman is 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), Tim Congdon (Institute of International Monetary Research), Jamie Dannhauser (Ruffer LLP), Anthony J Evans (ESCP Europe), John Greenwood (Invesco Asset Management), Julian Jessop (Independent Economist), 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), Juan Castaneda (Institute of International Monetary Research and University of Buckingham).