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Shadow Monetary Policy Committee

November 2013

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Shadow Monetary Policy Committee votes six/three to raise Bank Rate in November

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 15th October, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 7th November. Four SMPC members voted for a ½% increase, two members wanted an increase of ¼%, and three wanted to leave rates unaltered. This pattern of votes would deliver an increase of ¼% on normal Bank of England voting procedures.

There were a variety of reasons why a majority of the IEA's shadow committee wanted to raise rates now rather than wait until the recovery had gathered momentum and was incontestably apparent. One was a desire to start the process of interest rate normalisation sooner rather than later to avoid a damaging over-steer in the opposite direction, perhaps after the likely May 2015 general election. Another reason was to warn people thinking of taking out mortgages to buy properties, which still appeared significantly over valued by historic standards, of the potential capital loss they were taking on when (or if) rates returned to normal. Both SMPC hawks and doves agreed that the recent UK data had been stronger than was expected earlier this year, although the poll was compiled before the 'flash' output measure of UK GDP in the third quarter was released on 25th October, which showed quarterly and annual rises of 0.8% and 1.5%, respectively. The main disagreement between the two groups was over the margin of spare capacity still available. The doves believed that ample spare resources remained while the hawks thought that there had been a major reduction in aggregate supply as a result of the 'big government' policies implemented since 2000.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. 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. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members because it is impractical for every member to vote every month. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. As a result, the nine independent analyses should be regarded as more significant than the exact vote. The next two e-mail polls will be released on the Sundays of 1st December and 5th January, respectively, while the next quarterly SMPC gathering will be held on Tuesday 14th January and its minutes will be published on Sunday 2nd February.

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Minutes of the meeting of 15th October 2013

Attendance: Phillip Booth (IEA Observer), Jamie Dannhauser, Anthony J Evans, John Greenwood, Kent Matthews (Secretary), Patrick Minford, David B Smith (Chairman), Trevor Williams.

Apologies: Roger Bootle, Tim Congdon, Graeme Leach, Andrew Lilico, David H Smith (*Sunday Times* observer), Akos Valentinyi, Peter Warburton, Mike Wickens.

Proposal to the Committee

Suggestions for future meetings

The meeting opened with a discussion about voting procedures at the SMPC, initiated by a proposal from Patrick Minford. No final decision was made but it was agreed to ensure that all members had an opportunity to have their say prior to making a final decision. The committee also discussed a proposal to split future discussions into two parts: a discussion of current monetary issues (and the associated voting), and a discussion of a key current issue or topic of theory in economics to be led by one of the academic members. Again, no final decision was reached. However, it was felt that other members not present should all have an opportunity to have their say.

Economic situation

'Minsky moment' and the phases of private and public borrowing

John Greenwood began his presentation with a schematic diagram (below) showing how debt-to-income ratios behaved during the course of bubbles and busts. He said that he wanted to examine what happened to debt when a bubble reached a so-called 'Minsky moment'. It was after this point that private borrowing seized up and the government stepped in with a fiscal stimulus. At first, the private sector deleveraged but, ultimately, the public sector also had to deleverage. Case histories such as Canada and Sweden showed that the running down of debt ratios typically took twice as long as the time to run them up. The stylised diagram described the phases of boom and bust of the private sector and the public sector. In the bust phase for the private sector, monetary policy was ineffective – the pushing on a string syndrome or as Keynes described it, the 'magneto problem'. The phase description can also be used to explain why the USA had recovered faster than Europe or the UK.

Broadest measure of money includes shadow banks

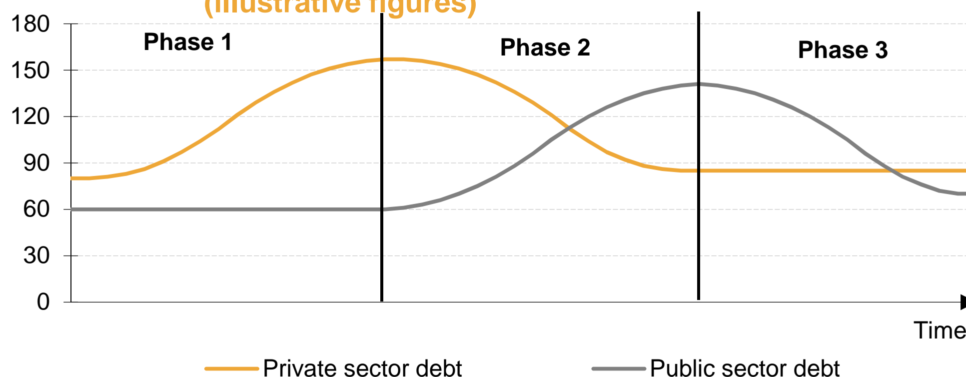
Although growth in the USA had been sub-par since 2008, it had outperformed the UK and the Eurozone in part because the US was further ahead in the deleveraging process. The USA was still in the deleveraging phase (Phase 2). Bank lending was still sluggish and money supply growth had therefore been critically dependent on Quantitative Easing (QE). If the broadest money supply measure was taken to include the shadow banks (M2 *plus* shadow banks' liabilities), monetary growth was weak with households likely to continue to deleverage for two to three more years.

The slow pace of recovery – US in front, UK second, Eurozone third

Turning to Europe, deleveraging had occurred later and at a substantially slower rate. Negligible M3 growth would constrain an economic upswing. The Eurozone risked repeating the experience of Japan where the failure to de-leverage had spawned Zombie companies, Zombie banks and Zombie households. Even after two decades Japan's private sector had deleveraged less than the US had done in the past five years. In the UK, the private sector was also deleveraging but at a slow pace (especially the banks). A ranking of economies in the deleveraging phase had the US ahead of the UK which was in turn ahead of the Eurozone economies.

Diagram: Two overlapping bell curves – Model of a debt crisis in three phases

Ratios of public and private sector debt to GDP (illustrative figures)



UK GDP showing signs of sustained recovery

UK GDP was showing signs of sustainable recovery. There were three reasons for this. First, monetary stimulus was beginning to work. Second, the external headwinds were diminishing. Third, the economy was being pushed forward by pent-up demand. The monetary numbers were moving in the right direction. The Funding for Lending Scheme (FLS), the relaxation of liquidity rules and Help to Buy, were coming through in an increased lending for housing. External constraints had loosened but the key difference in the global recovery was the different way in which the US had treated the banks compared with the UK. An aggressive, ***systemic*** recapitalisation of US banks through TARP had the government acquiring the preference shares of over two hundred banks, in contrast to the ***ad hoc*** programmes of recapitalisation in the UK or the Eurozone. The provisions restricting payment of dividends on ordinary equity and restrictions on staff bonuses, when combined with the obligation to pay progressively higher dividends on the government's preference shares, created incentives for US banks to clean up their balance sheets through massive write-offs and capital-raising. The table below summarises why the US led the UK in the recovery.

But sustained UK recovery depends on real income growth

However, a sustained recovery in the UK required real disposable income to show stronger growth than current figures. Real earnings had been falling and real disposable income growth remained weak. While demand led, the UK was still in the early stages of recovery.

Discussion

'Divisia' money rising fast

The Chairman then thanked John Greenwood for his excellent presentation. He said that, in keeping with tradition, he would ask the IEA Observer, Philip Booth, to make a vote as the meeting had been inquorate and added that that one further vote would be required in absentia (*Editorial note*: this was supplied subsequently by Andrew Lilico). David B Smith then started the discussion rolling by asking the views of the committee on the marked pick up in the annual growth rate in the Bank of England's 'Divisia-money' measure. This had accelerated from a low point of minus 0.5% in February 2012 to 8.5% in August 2013, or from 2% in January 2012 to 8.9% in August 2013 if the deposits of 'other financial corporations' are excluded. Their former SMPC colleague, Peter Spencer, had been an advocate of Divisia money in the past.

Although David B Smith had no strong views, this seemed a noteworthy development, which had coincided with the rebound in UK activity. Jamie Dannhauser said that the more rapid increase in Divisia money reflected the rise in M1 growth that had been stressed by some City economists. Both Jamie Dannhauser and the Chairman agreed that it was broad money that acted as the accelerator, albeit with long and variable lags, while the role of narrow money was more akin to that of the speedometer. However, M1 provided confirmation of the increased activity being shown by conventional output and expenditure measures.

Table: Why the US leads and the UK lags

	USA	UK
Banks	Rapidly recapitalised; large loan write-offs; liquidity from the Fed.	UK Banks more leveraged; larger relative to GDP; greater reliance on non-deposit funding.
Shadow Banks	Twice the size of banks in 2008, but roughly equal in size now; still shrinking.	Large but not well tracked; still shrinking.
Households (Debt-to-disposable income)	Peak leverage:134% Recent leverage:109%	Peak leverage:170% Recent leverage:144%
Size of Government (2012)	Government (Federal, State, Local) Expenditure: 39.1% of GDP.	UK Government expenditure: 48.4% of GDP.
Fiscal Strategy	Maximum deficit: 11.9% (2009). Projected deficit: 5.4% (2013).	Maximum deficit: 10.8% (2009). Projected deficit: 7.1% (2013).

Sources: International Monetary Fund *Fiscal Monitor*, Organisation for Economic Cooperation and Development *Economic Outlook*, as at September 2013.

Regulatory induced blockages, housing and Eurozone dangers

Patrick Minford stated that the recession had been prolonged by regulatory-induced blockages in the credit channel and that credit was coming through at last, helped along by schemes such as FLS and Help to Buy, which had had a positive effect on construction. David B Smith said the ratio of house prices to permanent income was still roughly one standard deviation (or some 16½%) above its long-run mean. There was a risk that innocent young people were being sucked into the property market at over-inflated values by such schemes. Such naïve first time buyers could potentially lose a third of their capital if house prices reverted to one standard deviation below their mean ratio when (or if) interest rates were normalised. Jamie Dannhauser said that, while market sentiment had improved, the biggest danger facing the British economy remained the uncertain outlook for the Eurozone. Philip Booth said that one aspect worth emphasising in John Greenwood's table (above, row 4) was that the

government sector in the USA was so much smaller than in the UK. Big government sectors had adverse supply-side effects on the sustainable growth rate. It was dangerous to assume that most of the output shortfall compared with the trend prevailing before the Global Financial Crash (GFC) was down to inadequate demand rather than weakened potential supply.

Call for votes

The Chairman then called the discussion section of the meeting to a close and made a call for votes. In accordance with normal SMPC practice, these are listed alphabetically including the one vote cast in absentia.

Comment by Phillip Booth

(Institute of Economic Affairs and Cass Business School)
Vote: Raise Bank Rate by ½%.
Bias: Hold QE and start to reverse.

Monetary policy cannot be used to solve problems of the supply side

Philip Booth said that he was worried about using monetary policy to deal with problems that stemmed from the real side of the economy. He said that the underlying problems were on the supply-side. The planning system needed reforming to allow people to move from low to high productivity areas of the country. He said that the interest rate levied by the private sector was disconnected from the central bank REPO rate. Therefore, this was a good time to normalise rates and begin the process of getting back to normal real rates of interest in the order of 2% to 2½%. He said that Bank Rate should be raised by ½%, and that QE should be on hold with a bias to reverse.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate and QE.
Bias: Neutral.

Balance sheet repair in UK has been low

Jamie Dannhauser said that he shared John Greenwood's view about the UK. Balance sheet repair in the UK had been only moderate. In the USA, growth of 2% to 3% was possible. However, there was little sign of improvement in Continental Europe where there had been no deleveraging. Nevertheless, it was hard to dismiss the positive signals that the UK economy was giving about the strength of the recovery. Even so, the large margin of unused potential capacity in Britain meant that it was too early to start tightening. He voted to keep interest rates on hold with no bias on QE.

Comment by Anthony Evans

(ESCP Europe)
Vote: Raise Bank Rate by ½%.
Bias: No more QE.

Err on the side of too soon than too late

Anthony Evans said that the arguments for raising rates were growing and that it was dangerous to wait for overwhelming evidence. There had been significant damage done to the supply side of the economy. The Bank of England had painted itself into a corner as to when rates should rise. The conversation had shifted to the timing of the rate rise. He said that it was better to err on the side of caution by raising rates too soon rather than too late.

Comment by John Greenwood

(Invesco Asset Management)
Vote: Hold.
Bias: Neutral.

Given the level of capacity, inflation is not a problem

John Greenwood said that balance sheet repair was still on-going. The idea of raising rates now was premature. There was a need for growth to take root and be sustained for one or two years before monetary policy was tightened. He said that inflation would not be a problem for a couple more years, given the background of slow money growth over the past two years and the level of capacity available. He added that interest rates should stay on hold with no further QE but he reserved a neutral outlook with respect to the need for further QE.

Comment by Andrew Lilico

(Europe Economics)
Vote: Raise Bank Rate by ½%; no change to QE.
Bias: Raise Bank Rate further.

There is a case for a 1% rate rise, although this is not recommended

In his post-meeting vote in absentia, Andrew Lilico stated that the economy was now growing strongly and that the final justification for emergency levels of interest rates had lapsed. The real debate ought to be about how quickly we sought to get rates up to 2%. He added that there might be an argument for an immediate 1% rise. Indeed, he might well have advocated a 1% Bank Rate hike, if the general debate had been in a healthier place. However, he would be content if any early rate rise were enacted, as matters stood. The Bank of England was going to be far behind the inflationary and monetary growth curves when it finally did act. The fact that households were being encouraged to – and, even, subsidised to – borrow additional funds for mortgages whilst they dwelt under the apparent delusion that current interest rates could last was a scandal. In his view, the monetary authorities should be seeking every opportunity and every excuse to attempt to normalise rates so that the economy could revert to a sustainable equilibrium. Begin! Begin! Begin!

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ¼%.
Bias: To raise Bank Rate; QE neutral.

Inflation above target for so long is not consistent with a wide output gap

Kent Matthews said that, while he accepted much of what John Greenwood said, he came to the opposite conclusion for policy. Balance sheet repair had been weak because the economy was weak. He agreed that real disposable income needed to grow more than at current rates and that household spending would rise only if the prospects for growth improved. He said that he disagreed with what John Greenwood said about available capacity. He said that no one knew what the level of available capacity actually was but that inflation being above target for so long was not consistent with a wide output gap. If capacity existed it was that of zombie enterprises that should be allowed to fail so that credit resources could be re-allocated to the new and emerging companies that were finding credit conditions too tight. The capacity destruction that had followed the great recession needed to be rebuilt but this could only be done if credit conditions improved for new and emerging enterprises. The long

period of low interest rates had resulted in a misallocation of loanable funds and that was part of the supply side problem.

Markets need to be made aware that the long period of low interest rates is drawing to an end

Interest rates needed to be raised now so that the markets became aware that the long period of low interest rates had come to an end. The rise did not need to be large for expectations to change. Even a small rate rise would alter market sentiment that further rises will be forthcoming. Sterling would react and inflation, which had kept the UK at the top of the European inflation league, start to recede. This process would not be painless but there was little likelihood of a sustained recovery until capacity was rebuild and the supply side of the economy improved. Interest rates should rise steadily until a normal real rate of 2% to 2.5% was restored. He voted to raise interest rates by ¼% with a bias to further increases and no QE.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: Raise Bank Rate by ½%.
Bias: To raise Bank Rate.

Active gilt sales to raise rates at the long end

Patrick Minford said that the FLS and Help to Buy schemes were insufficient mechanisms for countering the negative effects of bank regulation and unblocking the credit channel. He agreed that the Bank should not wait until the economy heated up to act on interest rates. Interest should rise to normal rates and QE should be reversed. The process of reversing QE meant that gilts should be actively sold and that rates at the long end should also rise.

Comment by David B Smith

(Beacon Economic Forecasting and University of Derby)
Vote: Raise Bank Rate by ¼%; QE to be run off gradually through non-renewal of maturing debt.
Bias: Bank Rate to be cautiously raised to 2% before pausing and QE to be gradually unwound.

Limit to what demand policy can do when faced with supply constraints

David B Smith said that the unintended side effect of the 'big government' policies implemented in the US and Britain since 2000 had been to sharply reduce aggregate supply. Therefore, there was a limit to what demand-management policy could do before the economy came up against supply constraints. This meant that a lax monetary policy could only produce stagflation in the British case. He added that monetary policy should be regarded as having at least three separate elements: Bank Rate setting; funding policy, and regulatory policy, and that all three needed to be pointing in the same direction for policy effectiveness. This was not the case at present when unduly low Bank Rate and an expansionary funding policy (i.e., QE) were tugging in the opposite direction to the restrictive effects of over-regulation. He added that, for completeness, foreign exchange intervention by central banks could also have a major effect on domestic monetary conditions – so that monetary policy was a four-legged chair rather than a three-legged stool. While this was not an important UK issue at present, it clearly was in China and other 'dirty floaters'.

Regulations breeding regulations

The meddling sentiment that permeated the UK monetary authorities – and also Coalition politicians for cheaply populist reasons – was a throwback to the pre-Thatcher period of interventionist policy. In the late 1960s, David B Smith had been

misemployed as a junior Bank of England official seasonally-adjusting the balance sheets of some half a dozen individual clearing banks because the clearers had convinced the authorities that the bank lending ceilings then imposed needed to take account of the seasonal fluctuations in their loan books. We appeared to be drifting back into a similar system of crazy micro-interventionism today. The main difference was that in the 1960s intervention was employed to restrict the growth of bank lending and direct it into politically favoured sectors, such as exporters; today, it was being employed to boost credit extension and direct it into politically favoured sectors, such as housing. What we were observing was a clear cut example of socialistic controls breeding distortions that were then tackled with yet more socialistic controls in a vicious upwards spiral of interventionism.

Be prepared to reverse QE if broad money accelerates or sterling falls

An important reason for raising rates now was to warn house buyers in a market which remained overvalued that rates were abnormal and could not be expected to stay so low for long. Economic agents needed to be made aware that borrowing costs would inevitably revert to some long-term norm closer to 5% than their current 0.5%. He was undecided whether to vote for an increase of ¼% or ½%. However, he pointed out that the simulations on the Beacon Economic Forecasting (BEF) model presented in last month's SMPC submission suggested that it made little discernible difference either way. In the end, he advocated raising Bank Rate by only ¼% – primarily, in order to control any damaging 'shock' effects – and to let QE gradually unwind by not undertaking commensurate new purchases as the Bank's existing holdings of gilts gradually matured. David B Smith was not advocating aggressive sales of the existing £375bn stock of QE while the annual growth of $M4^{ex}$ broad money remained around the relatively subdued 4.3% recorded in the year to August and the sterling index remained around its present 82.5 (January 2005 =100). He would, however, be far more aggressive if monetary growth accelerated into the 7½% to 10% range or the external value of the pound fell significantly.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking and University of Derby)
Vote: Hold; no further QE.
Bias: Reversing QE naturally.

Higher Bank Rate will increase defaults

Trevor Williams said that the supply-side was important and that spare capacity might well be less than was generally thought because of the existence of zombie enterprises. However, broad money needed to grow consistently for a sustained recovery. The reduction in energy costs had made the USA more competitive. The US economy had been able to build capacity and the Federal Reserve had been helpful in unblocking the credit channel through TARP. In the UK, productivity was low and corporates were not investing. He voted to keep interest rates on hold and no further increase in QE but to allow QE to run-off through maturity.

Policy response

On a vote of six to three, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in November. The other three members wished to hold.

There was only modest disagreement amongst the rate hikers as to the precise extent to which rates should rise. Three voted for an immediate rise of ½% but two members wanted a more modest rate rise of ¼%.

All those who voted to raise rates expressed a bias to raise rates further. There was also a common view that QE should not be increased and a majority view that it should be reversed naturally through the phased non-renewal of maturing debt.

Date of next meeting

Tuesday 14th January 2014.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (Beacon Economic Forecasting and University of Derby). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Commercial Banking and University of Derby). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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