Shadow Monetary Policy Committee

12 October 2021

Shadow Monetary Policy Committee votes unanimously to raise Bank Rate at its October Meeting

For the first time since March 2018, the IEA's Shadow Monetary Policy Committee (SMPC) has voted unanimously to raise interest rates. Of the nine members that voted for a rise, eight voted for 0.15% to take the Bank rate to 0.25%, and one voted for a rise to take it to 0.6%.

There was a bias amongst the majority of members to raise the Bank rate further in 2022, to 1%, though only if the economy recovered strongly enough and a lockdown was not reimposed. Regarding QE, there was a unanimous view that it should be halted but no consensus on when it should be reversed.

All members thought the UK's economic recovery was now strong enough to warrant moving to a tighter monetary policy stance. Moreover, chokepoints in the global supply chain are pushing up price inflation along the production process and hence into the broader economy. The risk that rising price and wage inflation became embedded in the economy via price expectations is made higher for most members by the fast growth in the UK's money supply. At close to a 10% annual rise in recent data, excluding intermediate financial institutions, most members felt it was well above a rate consistent with price stability, and so the 2% medium-term inflation target.

Members reiterated the limits of monetary policymakers to deal with some of the issues created by the supply and production issues plaguing the recovery from the pandemic. Monetary policy decisions cannot put cargo ships in the right place or deal with the inventory backlog or the energy and lorry shortages. Its focus is to maintain price stability and sound money, as the 'real' economy issues are addressed through other channels. Costs related to climate change were also discussed, and these, too, have inflation implications. Even with the rate rises indicated by members, real interest rates (nominal rates adjusted for price inflation) would still be negative, supporting economic expansion.

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 12 October 2021 (Held by Video Conference)

Attendance: Roger Bootle, Juan Castaneda, Andrew Lilico, Kent Matthews (Secretary), Trevor Williams (Chair), Peter Warburton.

Apologies: Julian Jessop, Tim Congdon, Patrick Minford, John Greenwood, Jamie Dannhauser

Chairman's comments: Trevor Williams said that Peter Warburton would deliver the background paper and invited him to make his presentation.

The Background

Peter Warburton said that the global economy's consensus is that the current rebound's momentum in 2021 will continue at a similar or slightly slower pace. The consensus is that growth in 2022 will be 4.4 per cent with little dispersion across countries and that the inflation pressures we currently see will abate over the next few months. He said this was a highly optimistic view, which he did not share, for reasons he will explain.

The Insight from Insolvencies

Underlying insolvency pressures are elevated

To give a clue to his thinking, Peter Warburton said that global insolvency pressures are building. A look at US bankruptcies show that business bankrupticies are running 40 per cent lower than in the previous year. Given US fiscal and monetary largesse, it can be argued, why would anyone default? But government cannot sustain this extraordinary level of support for much longer. Also, fractured supply chains are taking time to rebuild and the patterns of consumer demand in the reopening phase have shifted relative to those prior to lockdown. There is the potential for a surge in global insolvencies next year, which will consolidate the leftward shift in the global supply curve, imposing serious constrants on growth. After the sugar high of 2021, it is likely that world recovery will falter, dragging growth well below the 4 per cent consensus. He said that China may prove to be a big disappointment in 2022.

The Global Economy

Nationalisation of credit….and indefinite debt forbearance.

Peter Warburton said that the conventional objective of monetary policy has been replaced by a bizarre redefinition in terms of full or over-full employment. The financial stability objective has shifted from ensuring that the system is adequately capitalised to withstand adversity to the minimisation of default through zero interest rates and indefinite debt forbearance. He said that this was a very troubling state of affairs. In the context of the pandemic, the state has re-emerged as the dominant economic actor and has taken control of credit creation. By effectively nationalising credit creation, the state has weakened bankruptcy-insolvency mechanisms and provided implicit or explicit guarantees. The UK is one of the leading countries in terms of the size of this guarantee. It is likely that the difficulty of withdrawial of these measures will be proportionate to the amount of intervention undertaken in the first place. Central banks and governments have acted in concert to subvert market mechanisms in this emergency. In the case of US, UK, Canada, and Australia, colossal budget deficits have been largely monetised through central bank balance sheets.

Peter Warburton said that ever since the GFC, bank credit creation in respect of the non-financial private sector has responded weakly to the cheapness of credit. The pandemic-related surge in bank lending, supported by state guarantees, has disspated already. The growth in monetary aggregates reflects the monetisation of public deficits, rather than bank lending to the private sector on a commerical basis. Real monetary growth has been significant in most countries and although

broad money has slowed recently, the overshoot is still significant. Even now, the annualised growth rates of broad money is around 8 to 10 per cent in most advanced.

Affordable credit unavailable.

Despite rock-bottom interest rates, in some ways credit conditions are getting tighter. Banks are fearful of lending to individuals and SMEs, which are forced to self-finance, seek trade credit from supply-chain partners, or use a government-sponsored loan scheme. This is particularly so for micro businesses and sole traders. Bank lending growth, in both the developed economies and emerging markets, has fallen back significantly this year. In US, credit growth has fallen back from 9 per cent to 4.8 per cent, and in the UK, from 7 to 1½ per cent.

Negative credit impulse in G3 economies.

He said that a chart of the global credit impulse, constructed as the change in private sector credit divided by GDP for the US, China, and Eurozone combined, shows a line plunging down the page. If this chart is tracked against global PMI, you would expect a very weak outlook for the global economy. However, the chart is misleading in two ways: G3 private sector credit includes state-guaranteed bank loans, which is pandemic bridging finance. Repayments of these loans is a good thing – not a bad thing! Also, public sector credit creation through deficit finance remains unusually strong, providing a buffer for the global economy in 2022.

Rising inflation expectations.

Peter Warburton said that clearly there are some big real economy problems that needed to be confronted alongside the expansive picture for global monetary growth. He said that we have very slow delivery times, rapid producer price inflation, and a whole range of service prices that are going through the roof. There are some negative growth dynamics appearing in Japan and Germany. They have the orders but cannot get the parts. There is also the problem of floating goods inventory that can't get to market because of the backlog of offloading at the ports. In this environment, it has been impossible to rebuild inventory ahead of the seasonal consumer peak. Consumer demand is not being accommodated, with inflationary implications. In the US, the CPI components show that transitory components are softening but the non-transitory components are hardening. House price inflation is running in double digits in America and elsewhere. This is feeding through to imputed and actual rental costs, foreshadowing further inflation pressures in the coming months. Market implied inflation compensation rates have risen in US and Germany.

Foundation for stagflation.

In summary, on the international side, he said that serious problems affect production, transport, and consumption, and latent demand will express itself in inflation rather than growth. He concluded that there is the foundation for a transition to stagflation in 2022.

UK near term outlook

UK energy supply crisis overlaid on global goods supply crisis

Turning to the UK, Peter Warburton said that a European energy supply crisis has been overlaid on the global crisis in goods. The government is keen to see national output normalise and return to pre-Covid levels but the composition of economic activity is not the same as before the pandemic. There have been structural changes, and forcing more demand through a broken supply chain brings only inflation and frustration. The problem with the budget statement at the end of this month is how the public spending interventions can be turned off without causing a drag on the economy. An examination of the composition of the UK economy and growth sectors for July 2021 over July 2019 show some sectors racing ahead while others are well behind. The economy has a different shape and will continue to have a different shape in 2022.

He said that he expects that growth in the UK will fall back to the 1-2 per cent range in 2022, even as inflation remains elevated. This will put enormous political pressure on the Bank of England to postpone tapering and delay interest rate

rises. However, this pressure must be resisted in the interests of the longer-term health of the economy.

Monetary Trends in the UK

Lending and monetary trends softening.

Peter Warburton said that lending trends are softening, as are money supply trends, although household money growth is still 10 per cent. Lending to the corporate sector has tanked. Now that the guaranteed loan schemes have ended, bank lending to businesses has weakened. Mortgage lending has fallen back after the stamp duty holiday. But the housing market is still tilted towards quite strong appreciation due to the reluctance of vendors to sell. The danger is consumers are being unsettled by inflation and the measures taken to normalise the economy. Their mood is being disturbed, which will be expressed in weaker demand.

Labour market fractured and mismatched.

On the labour market, there has been some recovery of the employment rate. There is an extraordinary level of job vacancies and extraordinary acceleration in average earnings, which cannot be explained solely by compositional changes. It seems there is a fractured and mismatched labour market to go along with the fractures in industry supply chains. So again, it is unclear how easily vacancies will be filled at current wage levels.

To conclude, he said that Covid had provided a credible inflationary trigger, and we have lurched towards a command economy with a smaller SME sector. The public sector has validated a richer price level. Banks do not feel confident about lending to the real economy. High corporate profitability means that companies can afford to pay higher wages as they seek to resolve their logistical problems, helping to consolidate the move to higher inflation rates.

Discussion

Trevor Williams invited the Committee to make their comments.

Earnings catch-up?

Andrew Lilico asked if the earnings figures indicate some sort of catch-up where people had lost income in the down dip. Peter Warburton said that it is private sector wages that is driving up the numbers. There is a complex picture, including the exodus of Eastern Europeans. Andrew Lilico asked for greater clarification about the insolvencies argument as the data is mixed. Peter Warburton said that there was a regional dimension to his argument. The insolvency experience in Asia is unmitigated by public spending. But there has been very clear mitigation in the US, which is 40 per cent down on the previous year. The UK suspended some of the insolvency procedures last year, but it is well down on 2019. He said that the big question is whether we are confident enough about self-sustaining recovery to allow failure to occur.

Rise in administered prices

Roger Bootle said that what is extraordinary is the vast fiscal and monetary expansion. The two are linked and that there is no doubt that consumers ,not just in the UK, have the ability to increase spending. As he is an old-style Keynesian, he is concerned with costs and prices that don't correspond to normal market mechanisms. What is extraordinary is the number of places and sectors where prices are just being administered upwards. He said that we have just had the announcement of the national insurance social levy. There is going to be a large increase in the minimum wage. There is the drive to net-zero which will lead to a rise in costs and prices. There are massive cost pressures that will be passed on to consumers. He said that inflation will rise above 4 per cent and reach 6 per cent next year. It is possible that if the economy is as weak as Peter Warburton suggests, then inflation could come under control, and the authorities would look through it. However, he said that he was not confident that with the current

monetary and fiscal backdrop and consumers having such significant financial resources, this will happen.

Roger Bootle said that while Peter Warburton sees the Bank coming under increased pressure to not raise interest rates and defer the ending of QE, but he saw the exact opposite. He said that he sees the Bank coming under increasing pressure to raise interest rates. Roger Bootle said that what he sees is a period when inflation spreads out across different sectors at different times but over the next 6 months. He said that he expected the Bank to raise interest rates before the end of the year.

Rising prices consistent with different economic schools of thought

Phillip Booth said that Roger Bootle's point about the rise in administered prices could be brought into a new Keynesian, classical liberal, or Austrian framework. In these explanations, prices in different sectors increase at different rates and at different times when there is inflation of the money supply. This is what happened in the 1970s. What we have now is a supply shock and bizarrely the Bank of England thought it could offset the supply shock by a monetary expansion. He said that he would echo Roger Bootle's point without thinking about it in the same framework. There are sticky prices in many sectors, including those that are regulated. The news is full of supply shortages in every part of the economy, but what we have is consumers trying to spend the money that has been printed, and the supply shortages are just part of the inflationary process, which will lead to higher prices after a lag.

Juan Casteneda asked for clarification about the figures for lending to the private sector and in particular the difference between lending to SMEs and bigger companies. Peter Warburton refered to the chart on UK credit and money trends that showed the collapse in lending to PNFCs and non-intermediate OFCs.

Structural changes to the economy are delivered to price changes

Andrew Lilico said that he accepted the argument that a perverse monetary shock is a wrong response to a supply shock. But another thing is that a major structural shift in the economy is delivered through the price mechanism. So in some sectors of the economy, there is going to have price rises necessarily. There will be increases in wages for certain types of activity and there will be increases in prices. Eventually, there is a supply response and prices of these things will come back down. It is very difficult for policy makers to decompose those different movements when they observe changes in wages. The point is that prices will change because of long term adjustments to the economy from Brexit and the pandemic. Because of the difficulty of disentangling all these different effects, there is a case for raising rates, but it is tricky to know exactly how high. There is an element of experiment of trying a bit and then a bit more, and be flexible in reversing if necessary.

Roger Bootle said that there is a case for moving on interest rates quickly. The backdrop is an interest rate that begins at virtually zero with no historical precedent. So there is no doubt about which direction it has to move. He said that interest rates should move a bit but immediately. He said that he agreed with Andrew Lilico that rates should not rise in one big movement. There is a case for small rises and a 'wait and see' policy. The first move would be a rise of 0.15 per cent and see the reaction. Then make the next move a ¼% and move up in quarters rapidly during the course of next year. The first rise is less about the amount and more about signals to the market. In due course, there should be a reversal of QE.

Trevor Williams said that the implications of net-zero on costs and consumer spending have not been discussed. Phillip Booth noted that a monetary response to net-zero policy will be inflationary in the same way as the monetary response to the oil shock in the 1970s. He said that he would raise interest rates by ½% and not withdraw QE for the moment.

Votes.

Votes are recorded in the order they were given.

Comment by Roger Bootle

(Capital Economics)
Vote: Raise Bank Rate to 0.25%.
Bias: To tighten.

Roger Bootle said that the Bank rate should be raised by 15 basis points and raised thereafter in 25 bps in stages. QE should be halted, but reversal occurs in due course.

Comment by Phillip Booth

(University of Buckingham, St Marys University)
Vote: To raise Bank Rate to 0.6%.
Bias: To tighten and no further QE

Phillip Booth said that he was in favour of raising the bank rate by 0.5 per cent. Every time inflation rose, real rates were, in fact, falling. He said that there should be no further QE but not reverse QE at present.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate to 0.25%. To end QE.
Bias: To reverse QE after the end of lockdown. To raise rates.

Andrew Lilico said that he would like to see an immediate rise in the Bank rate by 0.15%, followed by further moderate moves. He said that QE should be reversed with the objective of raising the 10-year real rate to be no lower than zero.

Comment by Juan Castaneda

(Institute of International Monetary Research, University of Buckingham)
Vote: Raise Bank Rate to 0.25%. Halt QE.
Bias: To wait and see the effects of the first rise before further tightening and to reverse QE

Juan Castaneda said that broad money growth is still too high, even if decelerating and the market needed a strong signal that monetary conditions are being tightened. He voted to raise the Bank rate by 15 bps. He said that his bias is to see the effects of the rate rise on bank lending before further interest rate rises and expressed a bias to reverse QE.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To raise Bank Rate to 0.25%. No need to reverse QE at this stage
Bias: bias to tighten.

Peter Warburton said that he wanted to clarify his message in the presentation regarding the pressures on the Bank of England. If the UK economy grows more slowly than expected, this will make it politically difficult for the Bank to implement

tightening. However, his advice is that the Bank should signal a rise in bank rate to 0.25%, with a clear destination of 1% quite quickly. It is unnecessary to reverse QE at this stage as this would exacerbate the selling of gilts.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: Raise Bank Rate to 0.25%. Halt QE.
Bias: Bias to tighten and to reverse QE

Trevor Williams said that there is a rising risk of stagflation. The economy faces multiple challenges, and many of the solution does not lie with monetary policy. However, the Bank rate should be raised before the end of the year so that it is 0.25% and should be raised at each of the three quarterly meetings so that it reaches 1% by the end of next year.

But there are substantial cost pressures on consumers, and economic growth is likely to slow. Should the economy slow sufficiently to keep down inflation expectations and responds adversely to a modest tightening of 0.15%, then rate rises next year may not be necessary.

He said that the objective should be to squash inflation expectations. At the same time, he said that the UK has unique issues. The Brexit reality is that the economy has been partially dislodged from the global supply chain for goods and labour.

Monetary policy must act to put downward pressure on inflation expectations. QE should be halted, and the bond stock should be allowed to dwindle by the non-replacement of redemptions. This reduces some of the public finance pressures of not having to issue new debt at higher rates. He said there is the potential for the hike in short term rates to keep long term rates low and stable and, possibly, invert the yield curve.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate to 0.25%. Halt QE.
Bias: to reverse QE gradually and a bias to raise rates in small steps.

Kent Matthews said that he had been saying for some time that since the Global Financial Crisis, the policy of low interest rates and QE have stopped the goods markets from functioning properly in the Schumpeterian sense. He said that propping up uneconomic firms through monetary policy has created an allocative inefficiency in the economy. We are now seeing that as a result of a major supply shock, this allocative inefficiency is finally resulting in firms having to fail even in a low-interest environment. The statistics presented by Peter Warburton show a confusion of supply-side effects. Inactivity rates are rising, but vacancies are going through the roof. Output in some sectors falling but average earnings rising. The signal is that what the economy is facing is a host of relative price shocks mixed in with absolute price inflationary effects. It is difficult to disentangle the relative price effects from the absolute price effects. It is futile for the Bank to separate these effects, and it should stick to what it can do. The monetary data is pointing to an uptick in inflation, and interest rates should have been raised some time ago. He said that he would go with the majority and call for an immediate rise in Bank rate by 15 basis points to 0.25% and to follow through with further rate rises to reach 1% by mid-2022. QE must be stopped, and the process of reversal undertaken at a gradual and ordered pace.

Comment by Julian Jessop (in absentia)

(Independent Economist)
Vote: Immediate rise in Bank Rate to 0.25%. End QE.
Bias: To tighten.

End QE, immediate 15bp increase in Bank rate (to 0.25%), with a bias towards further tightening early in 2022. Despite some loss of momentum due to supply chain problems, UK economic activity remains on track to return to pre-Covid levels in the Autumn, which would be much sooner than the Bank had been expecting. Indeed, payroll employment is already higher than it was before the pandemic. With labour shortages and rising prices now the biggest threat, the time has come to start to return interest rates towards more normal and sustainable levels too.

Comment by Graeme Leach (in absentia)

(Macronomics)
Vote: To raise Bank rate to 0.25%. End QE.
Bias: Bias to tighten and reverse QE

The strength of inflationary pressures in the economy warrants an immediate interest rate hike and an end to asset purchases. Consumer price inflation is heading above 4%, and the spike may well be more enduring than temporary. Whilst the BoE still envisages a relatively temporary overshoot, the lagged effects of existing monetary growth suggest otherwise. M4 growth reached 15.3% (yr-on-yr) in February, and whilst the annual growth rate eased back to 8.2% (yr-on-yr) in August, the lifting of the lockdown will have accelerated the velocity of money. The end result is that the MV component is probably still running in double digits and even allowing for strong real GDP growth, implying inflation well above the target in 2022. Strong growth in the money supply was initially seen in asset markets and the acceleration in housing market activity. The monetary expansion is now feeding through into goods and services, most notably where supply shortages are most acute. Higher interest rates and the ending of asset purchases won't have an immediate effect on inflation, but they should begin to ease monetary expansion, and thereby inflationary pressures, into the second half of 2022. However, in the wake of the pandemic and the lifting of the lockdown, there is considerable uncertainty about the behaviour of the velocity of money, which could yet be stronger than expected. If so, further interest rate rises and reversal in QE may well be required.

Any other business

The Chairman said that the Committee should emphasise unanimous agreement that monetary policy could not be used to address real economy supply shocks.

Policy response

1. The SMPC voted unanimously to raise the Bank rate.
2. On a vote of 8 to 9 the Bank rate should be raised immediately to 0.25%
3. One member voted to raise the Bank rate to 0.6%
4. There was unanimity that QE must be halted.
5. There was a unanimous view that the Bank rate must rise in small steps with a majority stating that the Bank rate should be 1% sometime in 2022.
6. While some members of the committee voted to reverse QE immediately there was no consensus as to when this should begin

Date of next meeting

11 January 2022.

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 quarterly meeting held 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 (TW Consultancy, University of Derby, St Mary's University). 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), John Greenwood (Invesco Asset Management), Julian Jessop (Independent Economist), Graeme Leach (Macronomics), Patrick Minford (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (the University of York and Cardiff Business School), Juan Castaneda (Institute of International Monetary Research and University of Buckingham).