

Shadow Monetary Policy Committee

11 January 2022

Shadow Monetary Policy Committee votes to increase bank rate by 75 basis points to 1 per cent.

In the first meeting of the year, the Shadow Monetary Policy Committee voted to raise the bank rate by 75 basis points to 1 per cent. While there was unanimity for raising rates, there was a three-way split about the amount. Four members voted to raise the Bank rate by 100 bps to 1.25 per cent. One member wanted to raise the Bank rate by 75 bps to 1 per cent. Two members voted to raise the Bank rate by 50 bps to 0.75 per cent, and two to raise the Bank rate by 25 bps to 0.5 per cent. By convention - to get the rate that garnered most support - the Committee recommends a 75 bps rise in the Bank rate to 1 per cent.

All members agreed that the Bank rate was too low, that money supply growth was too rapid and was accommodating higher price inflation and that the level of inflation-adjusted interest rates was far too low. The latter boosted asset price inflation and distorts savings and investment. There was a view amongst some that the economy was strong enough to withstand a 1 per cent rate rise though one thought that a recession was likely in 2023, as money supply growth decelerated.

Other members who voted for more modest increases thought that the economy would not sustain its rebound if rates were raised too quickly - especially in the face of the likely cost of living squeeze in the spring. Another view was that financial markets were not expecting a 1 per cent rate rise at one meeting, and the central bank would not, therefore, make such a move without signalling to them for worry of a severe adverse reaction.

Despite the nuances, there is a unanimous call for monetary tightening to reverse the extraordinarily loosening of monetary policy during the Pandemic.

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 11 January 2022 (Held by Video Conference)

Attendance: Philip Booth, Juan Castaneda, Tim Congdon, Julian Jessop, Graeme Leach, Andrew Lilico, Kent Matthews (Secretary), Trevor Williams (Chair).

Apologies: Roger Bootle, Patrick Minford

Chairman's comments: Trevor Williams wished the members a Happy New Year and welcomed them to the first meeting of the year. He said that Graeme Leach is to present the background paper and invited him to make his presentation.

The Start of the Year – Some Profound Questions

Graeme Leach began his presentations by posing several questions. 1. Is Covid-19 moving to endemic status? 2. Is the inflation threat transitory? 3. Will inflation expectations accelerate? 4. Will wage growth rise with inflation? 5. Will monetary policy tighten more than expected? 6. What will be the impact of inflation on savings and the real balance effect? 7. Will savings accelerate in response to inflation as in the 1970s? 8. Has any post-lockdown consumer surge been and gone? 9. Will there be a significant acceleration in investment matching the increase in savings?

Accelerators and Decelerators

Graeme Leach set out a list of accelerators and decelerators in the economy. On the accelerator side, the potential to generate an investment surge. Other accelerators were:

The post-pandemic increase in consumption.

Reduction in savings.

The sharp fall in the velocity of money.

On the decelerator side, if inflation is not transitory, this could lead to a sharper tightening of monetary policy. There will be an erosion of real balances from a rise in inflation, and the increase in savings will moderate demand as real balances are rebuilt.

Erosion of real balances from inflation ... increase in saving

Global Pandemic to Endemic

Graeme Leach referred to the chart of the Coronavirus infection survey by the ONS, which shows that approximately 96 per cent of the population have antibodies for Covid-19. Despite the omicron variant, hospital admissions and critical care have flat-lined. He said that we are now fluid unless a new variant should arise. However, the signs are that we are at the beginning of the end. As a background to this, Graeme Leach referred to the global fiscal and monetary stimulus scale.

US money rising 30%...

He said that the IMF estimates of the joint fiscal and monetary stimulus ranged from 18% of GDP for the UK, 26% for the USA, and 54% for Japan. The USA has had the fastest growth in the money supply in its peacetime history. The latest shadow statistics show a 30% increase in broad money in the US. This has had a very clear feed through to asset prices. This is also seen in US corporate sector balance sheets which have gone from just under \$2 trillion to \$2.6 trillion in a short time. This indicates the potential investment spending power in the US economy.

US inflation expectations up....

The latest US CPI measure of inflation is 6.8 per cent in November and is likely to accelerate further in the coming months. The New York Fed survey of inflation on

median one-year ahead expectations show a rise to nearly 6 per cent, and the three-years forward to 4 per cent.

... but rising inflation expectations is not in the Fed's mindset.

He said that the National Federation of Independent Business Survey corroborates and complements the story of rising inflation expectations. The pricing survey has been at the highest level since the late 1970s. Although the capital spending plans do not show a stratospheric rise, they point to an expansion. The job-opening survey and the tightness in the labour market indicate that firms could accede to higher wage demands. However, this is not what is in the Fed's mindset. In the FOMC December 15 release, it is seen that the consumer expenditure deflator is projected to be in the 2.2 to 3 per cent range for 2022. Even allowing for the fact that this is not the CPI but the consumption deflator, it is still significantly lower than any realistic assessment.

Eurozone money clear acceleration.

Graeme Leach said that higher monetary growth has led to higher inflation in the euro area. Money growth was 0.9 per cent this time last year and 5 per cent on the latest measure, so there has been an apparent acceleration. Meanwhile, UK monetary growth has slowed significantly from its 15 per cent peak. But even at a lower rate of growth, it is not compatible with a low inflation rate, and there are long lags in the system. UK inflation is also on the rise, with CPI now at 5.4 per cent. He said that he was forecasting a 7 per cent peak in the first half of this year.

Energy prices and supply bottlenecks.

The consensus story is that inflation is transitory due to Covid and supply chain problems and the energy price surge, particularly in gas. Energy prices have risen sharply, and although gas prices have fallen back in response to market consequences, these price effects will come through into inflation. Earnings growth is not causing alarm, but a widening disparity exists across industries and sectors.

He said that it is unclear whether the widening will restrain the overall level of wage growth or if wage growth will rise in response to a tightening labour market.

Post-furlough job fears recede.

On the labour market, he said that there is good news. Employment is slightly higher than the pre-pandemic level, and hours worked is still slightly down. The redundancy rate is very low, and the post-furlough worries have receded. Unemployment has fallen back after rising initially, and as is well-known, vacancies are at a very high level in the economy. Consumer confidence has bounced around as it always has but is not showing any worrying signals.

House prices rising sharply.

House prices are rising at the highest rate in 20 years. The latest Halifax index is showing a 10 per cent increase year-on-year. The UK services PMI has come back from the shocking lows at the height of the lockdown and is now looking like business as usual. Household savings have fallen back from their peak, but the question is where do they go from here? Does inflation lead to a savings response, or will there be a post-pandemic consumption splurge? It could go either way. Retail sales have seen a post-lockdown bounce back but have now settled at around 2 per cent year-on-year growth.

Fundamental change in car market.

New car registrations are down about 20 per cent. Some of this is due to semi-conductor effects and shortage of new vehicles, but sales data may be misleading. There is a structural change underway in the car market. One in four cars purchased last year were some form of a hybrid plug-in, but the high price of electric vehicles is probably causing people to hold back from purchasing. So a combination of supply and semi-conductor issues pushes demand into the used car market. There is also a supply effect as people decide to run the existing car for a few more years, waiting for cheaper electric cars.

Graeme Leach said that there is a very significant inflationary threat for the first time in decades and invited the Committee to respond to his presentation.

Discussion

Trevor Williams said that Graeme Leach had raised many issues and provided much food for thought. He said that he highlighted inflation and the squeeze on household incomes; the UK gross debt position; the UK still having the highest COVID death rate in Western Europe despite a successful vaccine rollout; QE an effectively expansionary monetary policy; and finally are we experiencing a supply-chain shock that is already wearing off or are we back in the 1970s? He invited the Committee to make their comments.

10 per cent
inflation in US
possible

Tim Congdon said that the link between money and inflation is subject to lags. So even if there is a slowdown in money growth now, inflation will still come through in the next two or three years. In the 1970s the peak in money growth at 23% was in 1973 and inflation peaked in 1975. In the 1980s, high rates of monetary growth started in 1986 through to 1988, and inflation peaked in 1990. There is a 2-3 year lag. If the equilibrium is defined as a particular level of velocity of money, then in the UK, USA, and Eurozone, there is a large catch-up to deal with and inflation will be 5-10 per cent in most of these places. He said that he would not rule out 10 per cent inflation in the US. He predicted that the next few years will be ghastly and that we have not adjusted for the scale of the trouble coming. This is being made worse by the various kind of global salvationist things being done like the green agenda.

Will wages
respond to higher
inflation
expectations?

Andrew Lilico said that he had two questions about expectations arising from Graeme Leach's presentation. First, what will happen to wages associated with expected inflation in the future? Second, what will happen to house prices in anticipation of interest rate rises? He said that he saw some statistics that said that one-quarter of US households thought that inflation will be above 9 per cent in 12 months time. In these circumstances, people will not be satisfied with structural salary rises. People will want nominal pay rises above those of normal structural rises, such as promotions. He asked if there was any data that suggests that there was this second round effect? On the effect of interest rate rises, he said that once people think that interest rates start to rise, there is a race between house purchases and future interest rate rises as people bring forward their house purchase plans to lock in mortgages at lower rates, stimulating house price rises even further.

Graeme Leach said that there was a very clear break between inflation expectations in the USA and in the UK. He said that the median figure for inflation expectations by the NY Fed was 6%, whereas the Bank of England consumer price expectations survey showed a rise from 2.7% to only 3.2%. Regarding the feed through to wage inflation, he said that the evidence from the small business survey in the US suggests that the tightness of the labour market is such that it is difficult to believe that nominal wages would not respond.

Negative long term
real interest rates

Phillip Booth said that the term wage-price spiral is inappropriate. As Friedman described it, the increase in money growth feeds in to prices but these adjust differentially according to the degree of friction in individual markets. As a result of increased demand fed by higher money growth, there is labour market tightness, there are then wage demands, which pushes up costs and hence prices. The cause is monetary and this need not develop into a spiral unless the central bank validates it by printing more money. When people talk about gas prices causing inflation, they are wrong. Gas price rises are the consequence of the increase in the money supply. He said that he was also concerned for the prospects for real short term and real long term interest rates. Clearly real short term rates are much more negative today than the last time the SMPC met. But continued negative real long term rates is a serious issue. The lower long term real interest rates are,

the higher asset prices are likely to be. Particularly so for companies like Amazon who don't expect to make profits except in the very long term. If market real interest rates are genuinely negative there is not much we can do about it.

The end of asset purchases by the central bank will see money growth collapse

Tim Congdon said that he wanted to make two points about real interest rates. In the 1970s there was negative real interest rates and velocity rose. People wanted to hold less money relative to income and so any increase in money growth was more inflationary than it otherwise have been. We are not seeing a repeat of that as yet but it is a pattern we are likely to see in the next couple of years. He said that he did not expect to see big rises in interest rates. The reason is that the money growth that occurred in the past 18 months to two years has been the result of asset purchases by the central bank and monetary financing of the fiscal deficits. The asset purchases are about to stop but bank lending in the UK and eurozone is very weak. Also there is the problem of Basle 4 and banks being dragged into the green agenda, and capital weightings on dirty loans. In Europe if asset purchases by the central bank stops, money growth will fall very sharply. He said that the US was different where bank lending has recovered. But here and in Europe, once asset purchases stop, there will be a collapse in money growth. Inflation will come through from past money growth and real balances will shrink.

Positive outlook for business investment

Julian Jessop said that he was pretty positive about the near term economic outlook. Clearly the Omicron scare is fading. The labour market strength is not just good for wages but also for people thinking about job security. This means that people will feel more comfortable about spending the savings they have built up during the lockdown which will tide them over during any temporary squeeze caused by rising inflation over the next few months. There is also enormous scope for business investment to snap back from the lows following the Brexit vote and the pandemic. The Deloitte survey of CFOs show a positive outlook for business investment. He said that the outlook for 2022 looks bright giving the Bank of England the opportunity to bring interest rates back to normal levels. The cost of living rise is not going to be overnight. A lot of the hit to real incomes is going to come from higher taxes which will mainly affect higher income earners and not the relatively poor. The government has also done some things like the universal credit taper, and the increase in the national living wage which will soften the blow to low income earners. If interest rates are not raised in this period, the Bank will be missing a golden opportunity.

Juan Castaneda said that he agreed with much has been said. It has been noted that there are delays in the transmission of monetary policy and inflation will rise in 2022. As regards 2023 he said that he wanted to add to the comment on bank lending by Tim Congdon. There are two possible scenarios. One is the scenario Tim painted. The other is that banks are well-capitalized and in principle can significantly increase their lending. He asked if there is any data on bank lending that Graeme can comment on? Graeme Leach said that the private sector in the UK is going to respond like in the USA and he expects an acceleration in bank lending. He said that there is pent up demand and surveys covering small as well as big businesses about investment demand. Tim Congdon came back and reiterated his view that after 2022, real balances will decline as inflation and falling money growth interact leading to a fall in real balances and a downturn in the economy.

Votes.

Votes are recorded in the order they were given

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)

Vote: Raise Bank Rate to 1.25% and to end bank asset purchases

Bias: To raise rates.

Tim Congdon said that his focus is low and stable growth of the money supply and that he is in favour of a restoration of interest rates to normal levels which in the current context is 1-2 per cent. He said that he was concerned that the end of the year will see a sharp contraction in real money balances from which will proceed a nasty recession. Bank lending will not replace the halting of asset purchases and there will be a reduction in money growth and a bad recession in 2023.

He said he was initially in favour of a rise in Bank rate to ½ per cent but has been persuaded to raise by a full 100 bps. The SMPC needs to let the public know the gravity of the situation and to signal how grim the outlook is.

Comment by Phillip Booth

(University of Buckingham, St Marys University)

Vote: To raise Bank Rate to 1.25%. No further asset purchases

Bias: To raise rates

Phillip Booth said that inflation had reached levels that in 3 months' time when the SMPC meets again, real interest rates will be even lower. He said that he was in favour of raising bank rate by 100 bps to 1.25%. Real interest rates are intolerably negative which has problematic implications for monetary policy and household savings behaviour.

Comment by Andrew Lilico

(Europe Economics)

Vote: To raise Bank Rate to 1.25%. To end QE.

Bias: To raise rates.

Andrew Lilico said that he was bullish about the near term. The pandemic depression is likely to come to an end and the remaining restrictions be removed in the next 3 months. He said that the swift return to pre-pandemic normality was not priced in expectations of the economy at the last time the SMPC met. The implication of the lifting of restrictions is an acceleration of consumption and investment growth. There will be rapid growth in the near term. As to what happens further ahead, he said the inflation cycle will not be good, but how bad things will be is up in the air. There are some structural changes for the UK which makes it difficult to predict how things will be in the post-pandemic world. There will be more working from home, shift to the green economy, biotechnology, new trade agreements, etc. The Bank of England is a long way behind the curve, and he said that he favoured a rise by 100 bps.

Comment by Julian Jessop

(Independent Economist)

Vote: Immediate rise in Bank Rate to 1.00%. End QE.

Bias: To raise rates.

Julian Jessop said that the big picture is that interest rates are too low. He said that the economy is going to perform better than expected which creates a good window of opportunity. He said that he would go for a slightly lower rise because although he expects the economy to rebound strongly, the UK is still well below the pre-Covid trend in terms of economic activity. A 75-bps rise at a single meeting would be far higher than what the markets would be expecting. If signals are important then such a rise will be a significant signal. It also means that when interest rates reach this level, QE can be scaled back, and assets sold.

Comment by Juan Castaneda

(Institute of International Monetary Research, University of Buckingham)

Vote: Raise Bank Rate to 0.75%. To end QE.

Bias: To raise rates.

Juan Castaneda said the discussion about the rise in interest rates is important, but the timing is the issue. He said that the quantity of broad money created by the Bank of England, is the dominant issue. Ending QE is the most important thing as that has been the dominant factor in driving high monetary growth. But interest rates must rise. He said that interest rates should be in a normal range of 1-2% but that should move gradually. He said that he would like to see rates rise by 50 bps with continued rises in the year to reach 1.5 per cent.

Comment by Graeme Leach

(Macronomics)

Vote: To raise Bank rate to 1.25%. End QE.

Bias: To raise rates

Graeme Leach said that he would support a rise in the Bank Base Rate by 100 bps in order to address the fact that inflation was way above target and moving even higher. The source was not transitory but rooted instead in the monetary surge of 2020 and early 2021. The inflation problem was likely to be further exasperated by strong consumer and investment spending as the economy recovers from Covid, and the threat that higher inflation expectations could become embedded. The inflation threat needed to be brought under control with decisive action, even though he acknowledged that the monetary surge was more due to the actions of the central bank than the private sector.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)

Vote: Raise Bank Rate to 0.50%. End QE.

Bias: To raise rates

Trevor Williams said he voted for a rise in Bank rate by 25 bps and a reversal in QE by not rolling over maturing bonds. Many of the excess money sloshing around is because of the public sector, the government, and the monetary authorities

creating too much money. That is one of the sources of the inflation we are experiencing. But it is also the consequence of a Covid-19 inspired supply-side shock that drove the level prices higher. Inflation – a continuing rise in prices each year – is only likely after that price level adjustment (which was structurally unavoidable due to the pandemic) if validated by the authorities' loose monetary policy stance. Given the official liquidity constraints on bank lending, he said that he did not think the retail banks would be lending in an inflationary way.

On this basis, he said that the Bank should raise rates by only a ¼% at the next meeting and successive rises of ¼% at future quarterly meetings to reach 1% by August. By then, he expects price inflation to be past its peak, the economy to be slowing, and money supply growth M4 ex to have decelerated to a 1 to 3% pa range, eminently compatible with stable price inflation in the medium term.

Indeed, in his view, in 2023, medium-term growth is likely to be well below 2%, driven by structural factors such as an ageing population, trade friction, and slow productivity growth.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: To Raise Bank Rate to 0.75%. Halt QE.

Bias: to reverse QE gradually and to raise rates.

Kent Matthews said that while he understood the arguments proposed by Tim Congdon, he said that he was unsure what would happen to economic activity in 2023. The excess savings held as precautionary balances could be used to smooth consumption over the next two years. It is hard to know how the economy will respond without the aid of a general equilibrium model. The retail banks may not offset the effect of the halt in QE and money growth may fall, but that does not mean that credit creation slows. The excess liquidity in the system can find its way to firms and SMEs through the non-bank sector, such as P2P, VC and the like. The thing about predicting bad outcomes is that if economic agents learn to expect bad outcomes, they can take steps to avoid the worst of it. This is the difference between expected and unexpected outcomes. He had been saying for some time that interest rates should be raised in small steps. One of the arguments for this gradual rise is that it signals to the markets the direction of monetary policy and by making small steps it would not be necessary to raise rates precipitously and to return to normal rates too quickly. The Bank of England has chosen not to raise rates until now, and members of the SMPC have gone from proposing small steps to jumping to a rise of 100 bps in one step. At this point in time, this is not a credible proposal because it is very unlikely the Bank will make such a move. Even if a rise in rates of 100 bps is warranted it is not what the markets expects. He said that he votes for a rise in Base rate of 50 bps. Even a rise by 50 bps may not be what the market expects, and the signalling effect of a small, unexpected rise may be all that is necessary to galvanise expectations with its effect on the exchange rate and the bond market. Several members of the SMPC have expressed the view that the bond market is bonkers. He said that the market may be bonkers some of the time, but they cannot be bonkers for all the time, and they have been behaving in this way for quite some time. Decisive action by the Bank could be the pivotal point that has the market revising expectations rapidly.

Comment by Peter Warburton (in absentia)

(Economic Perspectives Ltd)

Vote: To raise Bank Rate to 0.50%.

Bias: bias to tighten.

Peter Warburton said that he voted for an immediate rise in Bank rate by 25 bps

Any other business

The Chairman said that as there was not unanimity on the size of the rise in rates, the recommendation will depend on the first vote in absentia. Like the actual MPC, if there are differences in the votes for the scale of the rise, he would propose a rate rise that would be acceptable to the majority

Policy response

1. The SMPC voted unanimously to raise Bank rate immediately
2. There was unanimity that rates had to rise further.
3. There was not unanimity on the scale of the rise in Bank rate
4. Four members voted to raise Bank rate by 100 bps to 1.25 per cent
5. One member voted to raise Bank rate by 75 bps to 1.0 per cent.
6. Two members voted to raise Bank rate by 50 bps to 0.75 per cent.
7. Two members voted to raise Bank rate by 25 bps to 0.5 per cent.
8. In keeping with the voting convention, the Committee recommends that Bank rate be raised by 75 bps to 1 per cent.

Date of next meeting

12 April 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, University of Buckingham), 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 (University of York and Cardiff Business School), Juan Castaneda (Institute of International Monetary Research and University of Buckingham).