Minutes of the SMPC meeting of 12 April 2022
(Face-to-Face, Institute of Economic Affairs)

Attendance: Philip Booth, Tim Congdon, Julian Jessop, Graeme Leach, Andrew Lilico (Chair), Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams.

Apologies: Roger Bootle, Juan Casteneda, John Greenwood

Chairman's comments: Trevor Williams relayed the proposal by Jamie Dannhauser that future face-to-face meeting of the SMPC could be hosted by Ruffer LLP. It was agreed that future face-to-face meetings of the Committee would rotate between Ruffer LLP and the IEA. Trevor Williams then handed the chairmanship over to Andrew Lilico. Andrew Lilico thanked Trevor Williams for his Chairmanship and invited Julian Jessop to make his presentation.

Global overview

Supply issues persisting post Covid

Julian Jessop said that he will start with a snapshot of where the world economy was in March. The Composite PMI Output indices show the % of firms saying output is higher than the previous month minus the % saying output is lower. The figures indicate a sharp fall for Russia but also China showing a drop because of their dynamic zero-Covid policy. Elsewhere, the indicators point to improvement with the UK and Ireland topping the chart. PMI indicators of expected future output show that the UK and USA are the most relatively optimistic, but the eurozone has fallen back to the levels for Japan and China indicating the supply problems associated with energy dependence on Russia. Julian Jessop said that these sentiment indicators correlate well with output outturns. Supply problems are measured in the PMI indicators of global companies reporting lower output staff shortages and material shortages. These measures indicate rising staff and material shortages that go beyond the pandemic shortages. Near term inflation and cost pressures are rising sharply based on the PMI input costs and inflation figures.

The fallout from Ukraine has increased uncertainty which alone might be expected to be bad for the prices of riskier assets but that will also depend on the response of central banks. There are geopolitical and military risks with the potential for NATO involvement and other military involvement such as China in Taiwan. Nuclear or the use of unconventional weapons and cyber attacks are part of this. Specific economic threats are disruption to energy supplies, commodity shocks to cereals and metals, financial contagion, and finally the response of central banks. As an indicator of market sentiment, share prices have recovered. Most investors had divested their Russia positions since the Crimean takeover. Energy prices will stay elevated like the period of 2011-2014 when oil prices were above $100. There are two reasons why energy prices will remain elevated. One is the divestment from Russia. The second is the investment in green technology. Julian Jessop said that he expected energy to contribute about 1.2 per cent to the April CPI figure raising it to around 8.5 per cent.

UK vs the euro area

Drop in test and trace accounts for low February GDP growth.

Julian Jessop discussed the figures for the level of GDP for the UK and eurozone from Q4 2019. The UK economy had a sluggish recovery during the Brexit transition period, but since then GDP has accelerated and caught up with the eurozone economy and is forecasted to surpass it in Q2 2022 relative to the position in Q4 2019. He said that Brexit Britain is powering ahead. Other forecasters are more pessimistic with the February GDP figures showing a 0.1 per cent rise. He said that this was largely due to the large negative contribution of government spending on test and trace and the vaccines.

Excluding this factor, the private sector is bouncing back well and underlying GDP rose by 1% or more in both January and February. He said that he was more optimistic about GDP in the near term. Going forward he said that the vaccination programme will pick up with the 4th jab roll-out and health spending rising but the private sector is in good shape. This scenario is reinforced by the latest PMI composite output indices for the UK, US and Eurozone showing the UK moving ahead in February and March.

Covid update and the labour market

Covid intensive care patients flattening

Julian Jessop said that he had been tracking the Covid data closely, including case numbers and particularly the number of people in hospital specifically for Covid, and the number on mechanical ventilators. He said that the numbers on ventilators have not increased. He said that this supported the policy of learning to live with Covid. The challenge to the NHS is that it has to treat patients that have Covid seperately even if they are in for some other problem.

A Tale of two labour markets

Turning to the labour market, Julian Jessop said that the two main measures of employment are telling two different stories. He said payroll employment compiled by the HMRC is rising rapidly and surpassed the pre-Covid high point but the Labour Force Survey measure shows a more modest recovery. The LFS measure picks up self-employment and casual workers. It was starting to recover and then faltered in the recent months. The payroll numbers are being boosted by IR35 - the new tax rules that make it harder to employ casual workers, and the demand for greater job security. The LFS numbers are perhaps more meaningful as it accounts for those not returning to the labour force after Covid.

In the case of wages across the economy, earnings are rising at about 5 per cent. Private sector numbers are higher. Median pay in March is rising 6 per cent, with the National Living Wage up 6.6 per cent and the 21-22 year old rate increasing by 9.8 per cent.

Inflation matching broad money growth…..

Julian Jessop said that with inflation, it would be easy to explain what is happening based on broad money growth. The numbers show broad money growth surging in 2020-2021 and more recently falling. The simple story is that we are paying the inflation price of the rapid rise in broad money. He showed the Committee a chart of annual broad money growth advanced 18 months against consumer price inflation showing a strong match for the period 2014-2022. He said that the chart supports his forecast of inflation heading to 8 per cent or so and then falling back.

…but velocity returning to pre-covid level could result in even higher inflation

Tim Congdon questioned why inflation should peak at 8 per cent? If velocity reverts to pre-Covid levels, he thought that inflation could peak higher. He said that he expected inflation to rise to double digits before falling back and he expected a nasty recession in the next year. Andrew Lilico said that an alternative interpretation from the charts presented by Julian Jessop is that inflation takes longer to come down with falling money growth and therefore it could sit at around 8-7 per cent for some time even as broad money growth falls. Tim Congdon said that share prices will fall to reduce spending through the wealth effect. In 2023 real money balances will have to fall massively. Patrick Minford said that implicit in Tim Congdon's thinking is that monetary policy will be tightened that will drive the fall in asset prices. He said that he did not think the central banks will do this. Peter Warburton said that credit markets are tightening irrespective of what central banks are doing. He said that credit spreads are widening. Borrowers are subject to stronger due diligence. Philip Booth said that with regard to wealth effects, that in the crash of 1987 this did not materialise as expected and he asked how strong these wealth effects are in reality. He said that labour markets are a lot more flexible and able to absorb shocks.

Conclusions

Active Quantitative Easing

Julian Jessop said that the consensus for UK GDP is too pessimistic. He said his forecast was for a growth rate of at least 1 per cent in the first quarter compared with the BOE of ¾ per cent and the OBR forecast of ½ per cent. He said that concerns about the global backdrop have made him shave down his overall growth forecast for the year to 5 per cent. On inflation, he said that he was expecting 7 per cent in March and then a peak of 8½ per cent in April before falling back to 3 per cent by mid-2023. To conclude, he said that the UK economy is doing relatively well and that the squeeze on real incomes may not be as severe or as persistent as many seem to think. The sharp slowdown in monetary growth should help bring inflation down but the risks are that the recovery could be threatened if the fall in money growth was too sharp. He said that there was a need to discuss Quantitative Tightening. The Bank of England has started passive QT by not reinvesting the proceeds of maturing gilts, but active QT is on the agenda, and it is something this Committee will have to address.

Discussion

Food price inflation could reach 20 per cent

Andrew Lilico thanked Julian Jessop and invited comment on the contrasting forecasts of inflation of 3.5 per cent in mid-2023 and the more pessimistic picture painted by Tim Congdon. Peter Warburton said that food price inflation could reach 20 per cent. The spring crop in Ukraine will not get planted this year – the fifth largest grain exporter in the world. He noted the interconnectedness of energy, fertiliser and food, making a sustained period of higher food prices a probability. Overall inflation will likely remain volatile for 3-5 years in the range of 5 to 10 per cent and this would be independent of monetary policy. He said that, over a number of years, central banks have become captured both by financial markets and by political forces and they have lost the freedom to counteract inflation

Central banks independence depends on their success

Patrick Minford said that Julian Jessop is basically right for two reasons. He said that the commodity cycle is a violent affair. He said that commodity prices went up by 100 per cent in 1918 and crashed down during the Spanish flu epidemic. Secondly, financial markets have got used to easy money. So if the Fed raises rates there will be a strong effect on the global economy. He said that he did not agree that central banks are captured by political forces. Central banks are organisations that cherish their independence. He said that there are strong survival incentives for them to meet their mandates. They will react with tight monetary policy and while inflation may not be down to 3 per cent by mid-2023, he said that they will trend towards that by the end of 2023. Trevor Williams said that QT is happening in the US. Estimates of QT of $100 bn is equivalent to a 25 bp rise on rates and he expects them to tighten further. Andrew Lilico said that he was sceptical about the falling away of inflation. Once inflation reaches 8 per cent workers start to react with wage demands or move to jobs with higher salaries which will create a persistence effect that will be sustained by the existing money stock.

Andrew Lilico brought the discussion to an end and asked members to vote

Votes.

Votes are recorded in the order they were given

Comment by Phillip Booth

(University of Buckingham, St Mary's University)
Vote: To raise Bank Rate to 1.75%. No further asset purchases
Bias: To raise rates

Negative real interest rates

Phillip Booth said that real interest rates are lower now than when the SMPC last met therefore he said that Base rate should be raised by 1 per cent to 1¾%. Raising real interest rates to zero would be too much of a shock to the market. He said that real interest rates need to be returned to positive but only slowly.

Comment by Graeme Leach

(Macronomics)
Vote: To raise Bank rate to 1.5%. End QE.
Bias: To raise rates

Economy needs to be squeezed harder

Graeme Leach said that we are seeing the consequence of the surge in money supply in 2020-21. He said that he did not feel confident that with negative real interest rates, rising headline inflation and a tightening labour market, that inflation would come down anywhere near close to target next year. He said that the economy would have to be squeezed harder and he prefered one single rise in interest rates to a drip, drip feed of rises. He said that he would support a rise in the Bank base rate by 75 bps bringing the Base rate to 1½%. This, combined with the slowdown in broad monetary growth in late 2021/early2022, should help to bring inflation back towards target.

Comment by Julian Jessop

(Independent Economist)
Vote: Immediate rise in Bank Rate to 1.25%. Start QT.
Bias: To raise rates.

Begin QT at £10 bn a month.

Julian Jessop said that he would start with Quantitative Tightening at £10 bn a month of active Gilt sales. He said that because he is advocating QT his decision on raising rates would be less sharp. He said that Base rate should rise by 50 bps raising bank rate to 1¼%.

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)
Vote: Raise Bank Rate to 1.75% and to control broad money growth
Bias: No bias.

Framework to control broad money growth needed.

Tim Congdon said that the point has already been made that it is the growth in broad money that is the main problem, and he is concerned about controlling the money supply. He said that broad money needs to grow at under 4% to meet an inflation target of 2%. He said that the banking system is being punished so much by regulation and capital requirements that capital is leaving the banking system. Lending to the private sector has nearly stopped. He said that QT and Gilt sales are not the issue. He said that Gilt sales have to support underfunding or overfunding to control money supply growth on a month-by-month basis. He said that inflation cannot come down unless the excess demand in goods and product markets get reversed to excess supply. He said that inflation will be very high next year, and real balances will have to fall first before we can expect a stable outlook in 2024 with a money supply growth of 4%. He said he was less concerned about the Base rate and more worried about broad money growth and would like to see a framework in place that places controls on it. He said that part of the problem has been the fixation on interest rates and not money supply. He voted to raise Base rate by a full 100 bps to 1¾%.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate to 1.5%. To begin QT.
Bias: to raise rates.

Tight monetary policy needs to be combined with loose fiscal policy

Patrick Minford said that broad money growth was already down to 4 per cent. He said that interest rates must be raised towards 2-3 per cent over the next year or so. To avoid recession, he said that there is a need for a more positive fiscal policy to move the economy off the zero lower bound. Monetary policy is ineffective at the zero lower bound. There is a need for interest rates to rise and fiscal policy to stimulate demand and stimulate supply. Current policy is restricting supply by raising corporation tax. When the real rate of interest is negative and lower than the growth rate there is a need to use stimulatory fiscal policy. Fiscal policy is needed to allow monetary policy to tighten. He said that Base rate should be raised by 75 bps to 1½%.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To raise Bank Rate to 1.00%. No change in QE.
Bias: No bias.

Fiscal contraction is baked into the system

Peter Warburton presented, as evidence for his cautious view, consumer wellbeing figures that are back to the depths of the Covid-19 and the financial crisis periods. The pressures of fiscal normalisation and negative real earned income growth would weigh heavily on the UK economy this year. While his longstanding position has been to bring Bank Rate back to at least 2 per cent, the severity of current circumstances would justify only a small rise in Base rate, of 25 bps. He said that real household disposable income probably peaked in the first quarter of 2021. The household savings rate has come back down 5.5% and was unlikely to fall further in the face of economic uncertainty. There is a big fiscal contraction baked into the system and he said that this was not the time to have a strong monetary contraction. He voted to raise Base rate to 1%.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: Raise Bank Rate to 1.0%. Start Quantitative Tightening.
Bias: No bias.

Trevor Williams said he voted for a rise in Bank rate by 25 bps and to begin Quantitative Tightening. Asset prices remain overvalued and reversing QE is not likely to result in an adjustment to this distortion. M4 money supply growth is falling and suggests price inflation will slow sharply over the next 18 months. In the interim, the peak in consumer price inflation will be over 8%. But there will be a sharp slowdown next year. Fiscal policy is being unnecessarily tightened and despite increases in the living wage there is a squeeze in household income.

Wage inflation remains well below price inflation. Money supply growth will contract before it starts to rise again.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate to 1.50%. To begin QT.
Bias: To raise rates.

Second round effects will keep inflation higher for longer

Andrew Lilico said that he votes for a raise in Base rate of 75 bps and QT of £10 bn a month. He said his bias is to raise rates further. He said there was considerable upside risk to inflation and that second-round effects will keep inflation higher for longer. Policy makers have allowed inflation to get too high and have got behind the policy curve. They now need to move more sharply on interest rates. In addition to money supply growth there needs to be a process of returning debt away from the government sector to the private sector.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate to 1.25%.
Bias: to reverse QE gradually and to raise rates.

Credit markets are already tightening

Kent Matthews said that markets are already pricing in a higher state of risk and spreads have been widening. Credit conditions are tightening, and the Bank of England is behind the policy curve. He accepted the points made by Tim Congdon that extra capital regulations have also hit bank credit growth. Either an increase in risk or capital ratios will result in credit tightening and spreads to widen. Shadow interest rates are higher than actual rates. Bank lending rates maybe low on paper but the evidence is that small firms are not getting access to credit at these rates or are not getting all the credit they want. He said that there was a need for fiscal policy loosening but that he preferred tax cuts to increased spending. He voted for an immediate rise in Base rate by 50 bps with a bias to further rises gradually and to reverse QE. He voted to raise Base rate to 1¼%.

Any other business

The Chairman said that there was unanimity that rates must rise but as there was not unanimity on the size of the rise in rates, the recommendation will depend on the rate rise that would be acceptable to a majority of the Committee.

Policy response

1. The SMPC voted unanimously to raise Bank rate immediately
2. There was not unanimity on the scale of the rise in Bank rate
3. Two members voted to raise Bank rate by 100 bps to 1.75 per cent
4. Three members voted to raise Bank rate by 75 bps to 1.5 per cent
5. Two members voted to raise Bank rate by 50 bps to 1.25 per cent
6. Two members voted to raise Bank rate by 25 bps to 1.0 per cent

7. In keeping with the voting convention, the Committee recommends that Bank rate be raised by 75 bps to 1.5 per cent

8. There was a majority view that QE should be reversed.

9. Three members supported the idea of combining the tightening monetary policy with the loosening of fiscal policy.

10. One member felt strongly that a flexible framework should be put in place to target broad money growth.

Date of next meeting

12 July 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).