Minutes of the meeting of 18 October 2022 (Hybrid, IEA)

Attendance: Graeme Leach, Andrew Lilico (Chair), Kent Matthews (Secretary, Online), Patrick Minford, Trevor Williams.

Apologies: Philip Booth, Julian Jessop, Tim Congdon, Peter Warburton

Chairman's comments: Andrew Lilico welcomed the committee to the hybrid meeting and invited Trevor Williams to explain what is going on.

Paradigm Shift

Headline inflation will fall back but world core inflation expected to remain stubbornly high

Trevor Williams talked of a market paradigm shift from low inflation, low-interest world to high inflation, high-interest world. The geopolitical backdrop to this change in the market in Ukraine, oil prices, the Russian invasion, and the interruption of supply chains. The measures show the financial market situation for volatility which has increased, and liquidity which has fallen. Leading indicators worldwide have fallen, with manufacturing PMI in the UK reflecting the sharpest fall to August 2022. The pandemic supply shock and war are driving up price inflation, evident in the food and natural gas prices. IMF projections for world inflation show a sharp rise before falling, but global core inflation is not expected to fall back as fast, remaining around 8 per cent at the end of the year. World central banks have been raising interest rates and global financial conditions to combat inflation. The result is that world growth is slowing sharply, with some countries expected to move into recession amidst low economic growth in others.

Global shift in fiscal and monetary policy mix

A global shift in the fiscal monetary mix is underway with more economies showing a move to a tightening of fiscal and monetary policy. Real interest rates are rising although still negative. Trevor Williams emphasised three points. First that the world is vulnerable to fiscal shocks, and fiscal default particularly economies over-exposed to the dollar and dollar strengthening. Second, dollar interest rates are also higher. So, there is an exchange rate valuation effect and a cost of borrowing effect. Third, market conditions for sovereign lending is tightening.

UK focus

Trevor Williams turned to the UK outlook which he said has deteriorated sharply in the year. He said that economic growth is projected to increase in the current year but fall in 2023 and 2024, with a consensus that a recession is unavoidable. CPI is expected to keep rising and peak at over 11 per cent by the end of 2022 before declining to 4-5% by end 2023. Bank rate is expected to rise 4-6 per cent. Consumer spending is expected to slow in response to rising prices and negative real income growth. Trevor Williams said that while the outlook is gloomy, longer term factors relating to the tight labour market, changing technology, and demographics, relate to planning and skills development, which are important for long term growth.

Stagnant productivity growth and higher inflation

Trevor Williams siad that the Bank of England projections are more pessimistic than the consensus. He pointed the committee to the Table of Bank of England projections that compared the economy's performance in the decade 1998-2007, and 2010-2019 with projections to 2024. He said that the two things to focus on is hourly labour productivity which had slowed dramatically in the second decade, and inflation which had risen. The chart of the monthly GDP outlook shows that there is almost no change in real GDP to 2025. ONS data showing which sectors had been most affected by the pandemic to January

2022 from January 2020 is revealing on where we have been. Graeme Leach and Andrew Lilico said that the performance of the worst hit sectors are already different and some are returning to normal.

Trevor Williams said that price inflation pressure is not just from energy, and that financial market expectations show bank rate is expected to rise. While markets are currently expecting Bank rate to rise to about 5 percent he said that the rise should not go higher than 4 per cent to reflect long term rates, inflation expectations, slowing growth, and the position of the yield curve. He said that if there is not another supply shock that would drive up energy costs next year, headline inflation will fall back sharply. The Bank of England will have been seen to have done its job. Therefore the Bank must not overdo the tightening. Fiscal policy canot be expected to offset monetary tightening nature because of the toxic political economy of the position of the deficit.

UK unemployment is expected to remain low despite weak growth. Patrick Minford said that the adjustment will probably occur with a fall in vacancies first. Unemployment stays low because of the increase in inactivity. Tevor Williams said that he wanted to also make a point about the tax burden hitting a post-war high.

UK Monetary Trends

QT could result in a fall in the stock of broad money

Turning to the monetary economy Trevor Williams said that broad money growth is slowing rapidly. QT will likely make the stock of money fall. Graeme Leach said that real money balances have fallen already. Trevor Williams said that with fiscal tightening, there is a danger of monetary over-kill. Consumer credit trends are showing a deterioration. Company borrowing trends are weak and SMEs are repaying debt in terms of bank loans.

Budget was meant to be tax cutting

The aim of the Truss mini-budget was to change the trend in UK growth. It was supposed to be the bigest tax cutting budget in 50 years. The new finance regime points to the likelihood of another period of austerity. There was a short discussion as to where the cuts would occur with no agreement among the committee as to the likeliest areas.

Trevor Williams said that the decline in sterling is a long term phenomena and that the rise in bond yields has been greater, and is more sifnificant than the fall in currency.

Discussion

Low interest rates are the reason pension fund vulnerability

Andrew Lilico made the point that the vulnerability of the pension sector to bond price falls is one of the outcomes of the low interest policies of the Bank of England and other central banks. When there is talk of the distortions from low interest rate polcies this one of them and is one of many problems that will start to become visible as interest rates rise and QT comes in to operation. He said that the capital losses to the Bank's balance sheet imply a negative cash flow on its income. Patrick Minford made the point that the consolidation of the balance sheets of the Bank and Treasury as part of the public sector means that the capital losses of the Bank gets recorded as capital gains for the Treasury and there is no net implication for the public sector.

QT to cause a tightening at the long end

Patrick Minford said that what it amounts to is a tightening of the long end and the short end and he is therefore doubtful about further QT. Andrew Lilico said that he accepted the argument about further QT but asked if here was a danger that if central banks in other counties raised rates higher and faster than the UKthe effect on sterling would be to raise import prices and stoke further inflation. Patrick Minford conceded that was a danger but that in terms of

inflation from supply side pressures he expected commodity prices to flip next year and inflation to recede. He said that the coming world recession and tightening monetary policy will cause inflation to fall next year. He said that monetary growth was high in 2020 but now globally is 3-4 per cent.

Trevor Williams said that the danger is the risk of over-kill in monetary policy and that 3-4% monetary growth was fine when there is a steady stable target rate of inflation but with core inflation projected to remain high in the short term the policy action of the Bank is critical.

Raising rates by less than expectations is a loosening of monetary policy

Kent Matthews said that according to Trevor's analysis, interest rates should peak at 4% and while the markets may expect rates to rise higher, they are not expecting that to happen immediately. The markets expect some rise imminently. When words like monetary over-kill are used, that is saying that Bank rate should not rise above what the markets expect. A rise of less than the market expectation is monetary loosening. Trevor Williams said the market expects interest rates to peak at 5.1% currently, and that overkill is when monetary tightening unnecessarily weakens economic growth.

Patrick Minford said that what the market expects is also a strong recession and a collapse in commodity prices. Therefore, there is a case for a positive monetary policy shock. Andrew Lilico said that given market expectations there is wide room for interest rates to change from its current position to 5.1%. Trevor Williams said that market expectations could be wrong, and central bank policy should not be dictated by market expectations alone but by facts. He said that when the reality of the downturn is known market expectations could change on a knife edge and expectations could switch from rate rises to interest rate cuts.

Votes.

Votes are recorded in the order they were given

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: Raise Bank Rate by 75 bps. Continue with Quantitative Tightening.
Bias: No bias.

Bank must regain credibility

Trevor Williams said that QT should have been done much earlier. However, rates should rise so that the Bank of England quells any doubts that it is not serious in its intent to bring inflation down. Base rate should rise by 75 bps to 3% and the Bank of England to deliver what the market expects to regain its credibility. The Bank should continue with QT to double down on what the market expects as a way of strengthening its credibility and lessening the need for Bank rate to go above 4%. With credibility restored it can start to cut rates in the second half of next year when the economy contracts sharply and inflation passes its peak..

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate by 75 bps. To begin QE.
Bias: No bias.

Bank should undertake QE

Patrick Minford said that the credibility of the Bank of England Is not an issue. Bond yields are signalling a tight monetary environment. Expectations are that rates will rise sharply. With fiscal tightening going on that will precipitate a recession, monetary tightening is excessive. He said that short rates should rise

more or less with expectations. But that he is in favour of a loosening at the long end with a return to QE. A signal should be sent out that long rates would not go this high. Long term rates of over 4% are too tight. QE is to be directed to drive down long rates. The Bank had set aside £65 billion but did not use much of it. He said that they should use that for now and defer QT indefinitely.

Comment by Graeme Leach

(Macronomics)
Vote: Raise Bank Rate by 50 bps. Slight bias for QE to keep growth rate of broad money above 5 per cent.
Bias: No bias.

QE to raise money growth

Graeme Leach said iinflation remains high at 10.1% and could peak around 11%. However, inflationary pressures are likely to subside rapidly in 2023 and the rate could well be below 5% by this time next year. The Bank of England misjudged the inflationary threat on the way up - and was late to raise interest rates - and looks likely to misjudge it on the way down as well, raising base rates more than is required. Broad money M4x growth has slowed from a peak of 16% (year on year) to 4.7% (year on year). In real terms the slowdown in broad money looks even more severe, with a contraction of around 5% (year on year) at present. Despite this, the Bank of England seems intent on raising interest rates in line with market expectations, and to pursue quantitative tightening as well. Recent market volatility has already pushed up mortgage rates and whilst base rates probably need to increase 50 basis points to help bring inflation under control, a 100+ basis point increase is likely to substantially weaken an already fragile economic outlook. The housing market was already overextended as measured by affordability (house price to income ratio), and debt servicing measures have recently deteriorated as well, for those not on existing fixed rate deals. The Bank of England risks a serious knock-on effect for financial stability if it raises base rates by a further 100+ basis points or more. There is already considerable GDP deceleration momentum in the system and yet markets expect interest rates to rise well above 5%. This is simply not credible when broad money growth is in deep negative territory already - in real terms - and the cost-of-living crisis is squeezing household spending significantly. To cap it all, the recent political and economic hiatus is likely to result in a fiscal tightening that risks overkill as well. As a result, the chances of a nasty recession are increasing by the day.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate by 75 bps. To hold QT.
Bias: to raise rates.

Market expects rates to rise

Kent Matthews said that validating market expectations of a 75 bps rise in Base rate would restore credibility to the Bank of England and the very hint of a delay to QT affecting bond yields shows the importance of expectations. He said that a rise of Base rates of greater than 75 bps would be overkill and anything below is a positive monetary impulse that endangers credibility. He said that he had no strong feeling about QT or QE as it is unclear what market expectations at the long end were reacting to. It could be monetary tightening through expected QT, it could be increased volatility, it could be expectations of looser future monetary

policy feeding into long term inflation. While extra QE deal with short term liquidity issues it might stoke up long term inflation expectations, so it is better to let the bond markets settle at its current state of an expected rise in Base rate.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate by 75 bps. Signal that QT is the medium-term objective.
Bias: To raise rates.

Know when to hold them and know when to fold them…passive policy

Andrew Lilico said that this is a situation where it is best to go with what the bond market thinks. He added that there are many other problems and not just the pension funds, associated with a rise in Base rate and he was not keen to bring them out any faster. Not going with market expectations on the short rate will have effects on the value of the currency, which will create political problems, which in turn will feed into gilt markets, and create more problems for the value of the currency. He said the passive policy appears to be to have a rise of Base rate by 75 bps and as little QT as possible. The medium-term stance is to let QT to arise naturally but to stand ready to stabilise markets with QE when necessary.

Comment by Julian Jessop (in absentia)

(Independent Economist)
Vote: Immediate rise in Bank Rate by 100 bps. Commence active QT in November
Bias: To raise rates.

Bank needs to tighten further

Julian Jessop said the recent political turmoil has increased uncertainty, but one thing is clear: monetary policy has been too loose for too long. Interest rates need to return quickly to more sustainable levels of around 4% to restore credibility and bring inflation and inflation expectations back under control. Indeed, if the economy and markets were not so fragile, there would be a strong case for getting there in one go.

Comment by Jamie Dannhauser (in absentia).

Ruffer LLP
Vote: Raise Bank rate by 100 bps. Stick to planned quantum of asset sales over next 12m; no gilt sales with remaining maturity 20y+; rebalance sales towards shorter maturity gilts

Bank needs to be aggressive even if the inevitable result is recession

UK monetary policy is dangerously behind the curve. The proximate trigger of the recent sharp tightening of UK financial conditions is the ill-conceived and disastrously executed 'mini-Budget'. But the MPC deserves plenty of blame. It dramatically misjudged the quantum and duration of desirable QE in 2020/21. It then failed to acknowledge the powerful domestically generated inflationary impulse building in the economy from summer 2021. Its judgement that covid-related supply-disruption would fade quickly was ill-founded and retained long after it became clear that it was unsound. More recently, in the wave of central bank tightening across the globe, the MPC has been stubbornly committed to its central belief that today's inflation surge primarily reflects "imported" inflation. Markets have, rightly, forced the MPC's hand.

It is imperative that the MPC moves quickly to bolster its damaged reputation and arrest the unpalatable dynamics emerging between domestic financial conditions and the value of sterling. Acting as market maker of last resort (MMLR) in a dysfunctional gilt market was the correct stance to take. But the ability of the Bank to act as MMLR depends, critically, on its reputation for taking the steps necessary to ensure price stability. The current inflationary impulse working its way through the economy may partly be a consequence of external factors; but this is far from the whole story. The labour market is as tight as it has been in decades; nominal wage growth is accelerating; and household and business expectations of future wage and price inflation are far too high. Aggressive action is needed now, even if the (now inevitable) result is a UK recession.

Comment by John Greenwood (in absentia)

(International Monetary Monitor)
Vote: Maintain Bank Rate at 2.25% but abandon plans to shrink the Bank of England's balance sheet
Bias: No bias.

Hold Bank rate, abandon QT

Since January of this year M4x growth has been in the 4-6% year-on-year range, exactly where it needs be to meet the 2% inflation target on a sustained basis. The inflation we are currently witnessing is the result of the excess growth of M4x in 2020 and 2021 (Andrew Bailey "Going big") when M4x growth averaged 10% year-on-year. Raising rates now to deal with current inflation is a case of closing the stable door almost two years after the inflation horse has bolted. While raising Bank Rate is necessary, it is equally important not to overtighten, driving M4x growth to unnecessarily low levels. In particular, the Bank's plan to shrink its balance sheet by £80 billion over the next 12 months is unwarranted and potentially dangerous.

When the BOE purchased securities in 2020-21, it created money (M4x) in the hands of the non-bank public, increasing M4x by £456 billion. Conversely disposing of £90 billion of securities to the non-bank public in 2022-23 will likely reduce M4x by a comparable £90 billion. Unless there is vigorous growth of lending by banks and building societies, sufficient to offset the contraction due to BOE disposals, there is a real risk of M4x slowing or even declining, which would exacerbate the recession the economy is unavoidably going to suffer anyway. BOE officials need to rethink their plans urgently. NB These problems are not alleviated by changing the mix of security sales between the long end and short end of the yield curve.

Once money has been created, it is unwise to withdraw it unless there are other sources of money creation to replace the funds withdrawn. During and after the GFC the problem was that bank balance sheets were impaired, so banks did not create loans or money and it was necessary for the Bank of England to create money in their place. During Covid, the Bank mistakenly thought that because it had created money in 2009-14 without creating inflation, it could repeat the same trick again. However, this time, not only were banks continuing to lend (they created £130 billion in 2020-21), but the Bank of England stepped in with a huge QE programme in addition.

Comment by Peter Warburton (in absentia)

(Economic Perspectives Ltd)
Vote: To raise Bank Rate by 25 bps. Abandon QT indefinitely
Bias: No bias.

Raise Bank rate, but abandon QT

As feared when I recommended only a 25bp increase at the previous meeting, financial stability issues have resurfaced. While blame has been laid at the door of the Truss-Kwarteng mini-budget on 23 September, I contend that this was a minor part of the story. Weeks before the mini budget, while knowing that whichever leadership candidate was successful there would be a significant relaxation of fiscal policy to address the energy price crisis, the Bank of England committed to press ahead with planned gilt sales of £80bn per annum. From being required to absorb around £50bn per annum, domestic private investors and foreign investors were prospectively being asked to provide upwards of £200bn, possibly £250bn per year. The additional unfunded tax cuts in the mini budget certainly amplified the problem, but a significant mismatch was already baked in.
The Bank's necessary interventions in the gilt markets have reinforced its new role as the guardian of financial stability and defender of the sovereign credit. To raise interest rates more aggressively would invite further pain for poorly positioned LDI funds and identify other potential sources of financial fragility. The defeat of the mini-budget and the replacement of the chancellor of the exchequer have reinstated the expectation of falling output and employment in 2023, lessening the need for stronger measures to deflate the economy, especially as the 31 October fiscal event may include further significant fiscal tightening.

Any other business

None

Policy response

1. The majority of the SMPC voted to raise Bank rate immediately
2. Two members voted to raise Bank rate 100 bps to 3.25%
3. Four members voted to raise Bank rate by 75 bps to 3 per cent
4. One member voted to raise Bank rate by 50 bps to 2.75 per cent.
5. One member voted to raise Bank rate by 25 bps to 2.5 per cent.
6. One member of the SMPC voted to keep Base rate unchanged
7. In keeping with the voting convention, the Committee recommends that Bank rate be raised by 75 bps to 3 per cent.
8. There was no consensus on the operation of QT. Three members voted to continue with a moderate QT.
9. Two members voted to abandon QT while two advocated actively reversing QT and undertaking QE.

Date of next meeting

10 January 2023.

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 (International Monetary Monitor), 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).