Minutes of the meeting of 11 April 2023 (Online)

Attendance: Philip Booth, Juan Castaneda**,** John Greenwood, Graeme Leach**,** Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams (Chair).

Apologies: Roger Bootle**,** Tim Congdon

Chairman's comments: Andrew Lilico welcomed the committee and passed the Chairmanship to Trevor Williams. Trevor Williams thanked Andrew for his chairmanship in the last year and invited Graeme Leach to provide his analysis and Kent Matthews to take the Minutes.

The Advanced Economies

Inflation or financial stability?

Graeme Leach stated that the mainstream view is that the inflation dragon will be slain by interest rate rises combined with an easing in global supply chain pressures and weaker energy and commodity prices. All this whilst avoiding any significant downturn. He argued that the mainstream view could be wrong and that the US and world economy could experience a very significant downturn and financial crisis due to: (1) Policy error by central banks continuing to raise interest rates. (2) The emergence of an inverted yield curve. (3) Sharp deceleration in broad money growth, which is falling in both nominal and real terms. (4) The undermining of bank capital by the rise in long term bond yields – and the unrealized losses on bank balance sheets which curtails future lending.

Graeme Leach argued that we could be seeing the chickens finally coming home to roost, with the malinvestment and overconsumption from central bank manipulated interest rates over the past 15 years, playing out as a result of the central bank reversal and tightening over the past year. However, he also acknowledged that central banks could yet again kick the can further down the road and focus their attention away from inflation and towards financial stability. However, if they did this the inflation problem would re-emerge again. The biggest current question is whether they can kick the can any further down the road and whether the day of reckoning has arrived? He stressed that he thought the current economic situation was grave.

While interest rates have risen, so far economic performance has remained

So, what has changed? China is back up and running post-Covid and supply chain pressures have eased. Similarly, shipping costs have fallen back, and energy prices have fallen back to where they were, but inflation has continued to rise. While goods price inflation has fallen back, services inflation has been sticky, particularly in the USA and the Euro area. However, there has been no sign of a wage-price spiral coming through. Inflation expectations, backed out of 5-year US bond yields have fallen back. Interest rates have risen along the spectrum, and one would have expected to see a greater negative effect on economic performance, but the latest JP Morgan global PMI figures indicate a resilience in global demand. The composite market PMIs are showing much fewer red signals than expected. The US economy is not flashing any danger signs.

Money supply growth and inverted yield curve signal recession

Why is this not happening? A substantial money overhang in the USA is working through the system. But the sharp slowdown in money growth, along with the steeply inverted yield curve, is signalling a move in the economy into negative territory. Real money supply growth is showing an even sharper decline. These signals are being seen also in the Eurozone and the UK. Only in the leading emerging markets of China and India, where there has been an acceleration in money growth in recent months, is there no sign of weakness.

For different reasons, the broader concern in the wake of the SVB and Signature bank problems and Credit Suisse are the unrealised losses on US banks' balance sheets. Recent research papers suggest that unrealised losses are as significant

Unrealised losses of the US banking system absorb

as the total of the banking system's Tier 1 capital. While these unrealised losses matter only in the case of bank runs, when banks must liquidate at market values, what is a source of concern is that the banks have had the biggest rundown of deposits in US history in March. This information, combined with the slowdown in monetary growth, is a serious cause for concern. The Federal Reserve has recognised the danger and expanded its total assets significantly. Another issue is how this relates to inflation, which is well above target. The fragility of the financial system in the US is wider. He said that 99% of US mortgage rates are below current market rates. The average house price to income ratio is higher than historical peaks. That was not a concern when debt servicing costs were low, but now that they are higher, it is a cause for concern. Graeme Leach concluded that the global economy has a lot of fragility.

UK Economy

Flat GDP growth forecast but weak money growth.

Turning to the UK, Graeme Leach said that consensus forecasts of GDP for 2023 and 2024 are better than they were in the Autumn. He said consensus forecasts are for a contraction in GDP of 0.6 per cent in 2023 and 0.8 per cent next year. He noted that the latest IMF World Economic Outlook predicts a drop of only 0.3% in 2023. He said that inflation projections are for a fallback, with the OBR saying that the inflation target will be met by the end of the year. But that's the good news.

The economy data is not alarming but monetary trends are worrying.

Higher mortgage payments kicking in this year will reduce discretionary spending power. Graeme Leach said that there is little slack in the savings ratio. Adjusting for pension equity shows a ratio close to zero. There is a wider housing market fragility in the UK and consumer confidence is fragile having recovered from the lows of last Autumn. Similarly UK corporate confidence has rebounded from last autumn but still looks vulnerable. One significant piece of news was that the services PMI has also edged up to above the +50 percent mark. The UK is looking much like the USA. The data is not showing up anything too bad but Graeme Leach said he was worried about what the monetary data was showing. Broad money weakness in the UK continues to add to fragility. Although there are special factors involved, annualised 3-month broad money growth is negative and again this is only nominal growth. The trend is worse in real terms.

To summarise, the UK situation is fragile. Graeme Leach said that the indicators in the housing market are worring given that mortgage rates are rising for 5 million mortgage holders. He ended his presentation and asked the committee to comment on whether he was being too gloomy.

Discussion

Trevor Williams thanked Graeme Leach for his presentation and invited comment.

Andrew Lilico asked if Graeme Leach had a view on the IMF's recent comment about the natural real interest rate being less than the natural rate pre-Covid. He said the report suggested that the natural rate will fall to 0.3 percent in the medium term. Graeme said that he had not read the report. Still, the natural rate was a somewhat elusive concept, but what we could be certain of was that central bank intervention had lowered actual rates significantly below the natural rate over the past decade. We could be about to pay the price for that price distortion. Andrew Lilico said that given Graeme Leach's presentation had focussed on the fragility of the banking system. He asked if getting inflation down in the US is consistent with financial stability and if we could expect a more extended period of inflation. Graeme Leach said that this is the Roubini argument, that you end up with stagflation. The problem is that the Fed has been consistently behind the curve,

Further rate hikes in the US could trigger the bank crisis

and they have intimated that looking at surveys and non-farm payroll data, there are further rate hikes to come. He said that more rate rises could trigger the problems he discusses for the US and the global economy. He said that he fears this will be a policy error that brings about the banking crisis, given the fragility of the financial system.

Markets will not operate properly if banks with bad business models are not

Trevor Williams said that the relative price effect of the Russian war would abate and is beginning to wane. The monetary overhang has been tackled and fallen to less-than-normal levels. He said that this was policy overkill. He said that markets would only operate efficiently if firms with bad business models were allowed to fail, and banks could not keep getting rescued constantly. There must be a way to allow them to fail. Graeme Leach said that the malinvestment and zombie firms' arguments of the Austrian School are coming true. If a financial collapse looks likely, the authorities will react to support the financial system, and there will be a medium-term inflation problem.

Legacy of excessive monetary easing

Trevor Williams said that as a committee we should record that monetary policy is not too loose and is doing the job of bringing inflation down and is possibly excessively tight, but the problem is the failure of the regulators to deal with the legacy of excessive monetary easing and QE that helped create the bank fragility that Graeme Leach talked about. He believed that there are solutions.

Paying interest on bank reserves makes money growth

Patrick Minford said that the interest payments on bank reserves transfer seigniorage to banks and distort monetary policy. Central banks already help commercial banks by providing LOLR service and paying interest rates on reserves; now those rates have risen, hindering monetary growth. John Greenwood said that the interest payment on reserves, which started with the Fed in 2011, was due to their obsession with controlling monetary policy solely through interest rates. The Fed and the Bank share the same view that inflation has nothing to do with the money supply, and the current inflation is driven by external events which they could not have done anything about. Before the GFC, the reserve ratios of banks were small and unremunerated. Hence the implicit tax on banks was trivial. By paying interest on reserves, the Fed reasons that monetary control through the interest rate would be easier. The result is that they need to pay more attention to monetary growth. From the commercial bank's perspective, placing funds on deposits as reserves is safer than lending in an uncertain environment. Monetary policy is too tight.

Unintended consequence of Fed policy.

Peter Warburton said that 80 percent of money market funds in the US are invested in government paper, which currently offer much better interest rates than bank deposits. Many US banks have an urgent need to divest Treasury securities but can only sell from their mark-to-market portfolios. Selling from the held-to-maturity portfolio would result in reclassifying the entire portfolio as mark-to-market and would force recognition of loss on a scale that could endanger their capital position. This situation is also happening in the UK as witnessed by the 3-month annualised negative growth in M4. Trevor Williams said that this is the unintended consequence of this policy that it hampers liquidity growth when bank lending is needed to help the economy grow. Juan Castaneda said that he agreed with Graeme's assessment and the explanations provided by John Greenwood and Peter Warburton. Adding to the squeeze on bank lending, the counter-cyclical capital buffers imposed on banks in the UK last year and new ones coming in July, make the prospects for bank expansion of balance sheets very poor. He said that we should be worried about deflationary pressures building up in the economy.

Phillip Booth commented on the mistaken views espoused by the Governor of the Bank of England Andrew Bailey on the causation of inflation and role of money. He said that for the governor to, in the first place, tell workers that they should restrain wage demands and, secondly, to exhort retailers to not increase prices, is to return to the way politicians used to talk about how to defeat inflation back in the 1970s. It is not a strategy based on a sound understanding of the cause of

inflation. When the Governor is wrong it is the right thing for the SMPC to correct him, either in these Minutes or in a letter.

To raise rates or to hold?

Andrew Lilico said that the real debate is between holding rates or raising rates. The argument for raising rates, is that first, over the past few months the performance of the economy is better than expected and the recession effect on inflation is weaker. Second, although wage inflation is not a driver of inflation, they are a predictor through the expectations effect. Third, other countries might over-inflate to address financial stability issues. We may then face imported inflation from other external reaction to stability issues. He said that his opinion is that rates have gone too far and asked if there were other arguments for interest rates rise that the committee should consider. Trevor Williams said that the remarkable thing is that wage growth is relatively low even with labour shortages. Graeme Leach said one argument for a rate rise, is that there is still double-digit inflation and people don't believe the OBR forecast that inflation will fall back to 2 percent by the end of the year. He said that the issue is not about interest rates but the growth of the money supply which is falling rapidly.

Trevor Williams brought the discussion to an end and asked that members indicate their votes.

Votes.

Votes are recorded in the order they were given.

Comment by Philip Booth

(St Marys University)
Vote: To hold Bank Rate. Maintain current stance on QT.
Bias: No bias.

Philip Booth said he accepted all the points made about monetary growth but that he has an aversion to micromanaging. Interest rates in real terms are still firmly in negative territory. He said that the best thing is to do nothing, which meant that the Bank should not change Bank rate and should not alter the announced policy of modest QT.

Comment by Andrew Lilico

(Europe Economics)
Vote: No change in Bank Rate. Maintain QT at the announced rate.
Bias: No bias.

Andrew Lilico said that he thought interest rates have risen too far but not vastly so. He said that the money figures show that the Bank has done enough and voted for a no change in Bank rate. He said that he could imagine situations in the future where rates might have to rise, or they might have to fall and therefore he has no bias.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To hold Bank Rate. Suspend QT.
Bias: No bias.

Peter Warburton said that QT should be suspended as there are too many risks regarding bank behaviour. He said that he would not rule out some intervention if the deceleration in lending continues. The intervention could be in the form of term funding of assets that cannot be currently collateralised. He said that there are worrying signs of public sector dysfunction. There has been a 13 percent increase in non-mainstream public sector spending (that is outside health, education, law and order, defence, etc.), which has necessitated an increase in taxation. We are misallocating resources from productive to non-productive sectors.

Comment by John Greenwood

(International Monetary Monitor)
Vote: Maintain Bank Rate.
Bias: No bias.

John Greenwood said that he wanted no change to rates and no bias, but any longer-term bias would be conditioned on what happens to money growth. Currently, money growth is too low. If the money numbers continue to decline, he would bias to an easing. A simple analysis of the money supply figures indicates a sharp fall in inflation in the latter part of this year is likely. No further tightening is needed.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To cut Bank Rate 25 bps. Stop QT.
Bias: Bias to no further rises.

Patrick Minford said that we are entering a period of instability and we need to get back to stability. There has been a massive tightening of money and that needs to be corrected. There was massive easing during Covid and now there is massive monetary tightening. He said that he is in favour of a cut in rates and a restoration in money supply growth. His bias is for rates to fall further in moderate cuts of rates of 25bps a time. He said that inflation will come down and we need to get money supply growth right to avoid a potential bank crisis that could result in another bout of excessive monetary easing.

Comment by Juan Castaneda

(Vinson Centre, University of Buckingham)
Vote: No change in Bank Rate. Halt QT.
Bias: No bias.

Juan Castaneda said that he agrees with John Greenwood's analysis and he agreed with Patrick Minford that we need to get back to monetary growth stability. He said that money growth is quite low there should be no continuation of QT.

Comment by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate. No QT
Bias: No bias.

Graeme Leach said there is still a certain amount of monetary overhang from the pandemic which is limiting the effects of low money growth. The effect of the low money growth rate has yet to show itself in the real economy. He said that the monetary condition is sufficiently severe, and that there should be no change to rates and to end QT. He said that while he agreed with Patrick's sentiment, he felt that a cut in rates could result in fuelling inflation expectations as markets could interpret this as going soft on inflation, which could then be reflected in higher long-term rates. Such was the lack of market grasp of the true underlying financial situation.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: To cut by 25 bps. Continue with Quantitative Tightening.
Bias: No bias.

Trevor Williams said that he had mentioned the dysfunctional policy of the regulators that had created the grounds for instability. The excessive monetary growth, post-pandemic, has now been addressed by QT. Monetary policy is now being over-done to deal with an inflationary problem that is no longer a problem. Monetary policy should be biased towards promoting liquidity growth at a time of liquidity constraints. He said that there should be a 25bps cut in the Base Rate and a continuation of QT. The Bank needs to reduce its holdings of public sector debt and return it to the private sector. QT meets the medium-term objective; the rate cut is to deal with the current problem of monetary over-tightness.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Hold Bank Rate. To hold QT.
Bias: No Bias.

Kent Matthews said that he saw no reason to change his vote from the previous meeting. He said that there is a difference between the effects of anticipated and unanticipated monetary policy and so far, monetary policy has responded according to market expectations and that is the main reason why there has not been a stronger real economy reaction to tightened monetary conditions. The market may be expecting a further rate rise but that a pause in the Bank Rate is a wait and see strategy that can be interpreted as a mild loosening. He votes for a hold in Bank Rate and to hold QT. The suspension of QT is a signal of a mild loosening as the programme of bond purchase is anticipated, but the suspension is part of the wait-and-see operation. He said that a sharp cut in rates from a high of 4.25 percent in response to a banking crisis would have a stronger effect on the markets than a cut from a lower position reached through small changes of 25bps a time. He added that he agreed with the view expressed by Patrick Minford that paying interest on reserves creates a distortion in the operation of monetary policy

that makes bank lending more responsive to interest rate changes and should be abandoned.

Any other business

Trevor Williams said that the Minutes should record the feeling of most of the Committee that the policy of paying interest on bank reserves stifles bank credit growth when credit is needed to support the economy. He says that though there was no majority to cut the Bank rate, the fact that most members voted to end QT suggest that the Committee feels monetary tightening has gone too far and some of it should be reversed either through resuming QE or lowering rates.

Policy response

1. The majority of the SMPC voted to hold Bank rate at 4.25 percent.
2. Two members voted to cut Bank rate by 25 bps to 4.0 percent.
3. There was no consensus on the near-term future of QT. Two members felt that QT should be maintained at the current pre-announced rate. On a vote of six the recommendation of the Committee is that QT be suspended
4. There was a strong feeling that the policy of paying interest on bank reserves distorts monetary policy and should be abandoned.

Date of next meeting

11 July 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), 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 (Vinson Centre, University of Buckingham).