Shadow Monetary Policy Committee

11 July 2023

Shadow Monetary Policy Committee votes eight one to hold Bank rate

The Shadow Monetary Policy Committee voted at its quarterly meeting in July to hold the Bank rate at 5%. The vote to hold rates was by a margin of eight to one. No member voted for an immediate cut in rates fearing that this would lead to a loss of credibility for the Bank of England. But a large majority wanted quantitative tightening (QT) to cease instead of a cut in interest rates.

Of those that wanted quantitative tightening to stop, two wanted this to be temporary, arguing that the distortions created by central bank purchases of so much debt had created mispricing and misallocation in capital markets. The fall in bond prices - and the corresponding rise in yields - would have been less severe had the Bank of England not had to reverse QE during a global inflation crisis.

The member who voted to raise rates and maintain QT was worried that inflation was becoming embedded in the economy and was everywhere all at once. This member felt that to restore its credibility in the eyes of the financial markets, and the BOE had to over-tighten because of its previous failures of being seen as 'behind the curve'.

Other members felt that the UK had no fundamental inflation problem and that its weak growth and supply-side issues meant demand could not create a permanent inflation problem. They saw it as a temporary issue created by previous excessive monetary growth because of QE and the supply side effect of the invasion of Ukraine. In that view, what was required was allowing the medicine of higher interest rates to work to curb inflation expectations. Moreover, QT should be stopped until interest rates start to reverse, as shrinking the money supply under current economic conditions would harm the economy unnecessarily.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. It was the first such group in Britain, and 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 July 2023 Ruffer (hybrid meeting)

Attendance: Jamie Dannhauser**,** Philip Booth, Juan Castaneda (online)**,** Tim Congdon**,** Kent Matthews (Secretary), Patrick Minford (online), Peter Warburton (online), Trevor Williams (Chair).

Apologies: Julian Jessop**,** Roger Bootle**,** Andrew Lilico Graeme Leach

Chairman's comments: Trevor Williams opened the hybrid meeting and thanked Jamie Dannhauser for hosting the meeting at Ruffer and for their hospitality. He invited Jamie to provide his analysis of the global and domestic monetary environment.

The Global Environment

Jamie Dannhauser said that this was a most interesting time that sees some genuine divergences across the major economies. China is the most obvious which has seen very little inflation. The US being the first out of lockdown and, also was the first to see a peak in inflation. The UK and Europe are different in that they have inflation that is far too high. On the real side, China after first being adamant that they were going to stay in lock-down, came out rapidly and therefore experienced a sharp re-opening wave. In Europe the sentiment in Q4 2022 was that Europe was sliding into recession. But a milder winter came and the pessimism about energy prices changed, and sentiment was reversed. There has been a remarkable turnaround in asset prices.

Stubborn core inflation and central bank tightening

He began his assessment of the global environment with a chart that showed some improvement in headline rates of inflation across the advanced economies. But underlying price pressure remains firm with core inflation across the G7 stubbornly high. Central bankers have responded with a collective hard step on the brakes. Global monetary policy proxied by the 12-month change in the weighted 2-year average bond rate shows an uptick of more than 50bps. However, he questioned if this heightened monetary tightening was enough. The level of interest rates is still low. Real policy rates are still heavily negative.

Recession signal in the US or a return to post-covid trend?

He said that global and German PMIs are close to historical figures that indicate recession. But that if you flip to the other side of the economy with services, the pandemic bottlenecks are clearing with spot and long-term contract rates of container shipping falling and upstream goods prices falling. Global PMIs have slipped back, but China reopening has fueled the global service sector. However, he questioned whether the China mini boom is fading at the same time as recession is indicated in the US.

Growth in real money in the US is strongly negative, possibly indicating a severe recession. But is the pandemic overhang in the level of real balances simply a return to the post-Covid trend? The market expectations are for a further rise in Fed Funds and euro deposit rates.

UK Economy

Bank MPC inflation forecasts serially correlated error after serially correlated error

Turning to the UK, Jamie Dannhauser showed a chart of the Bank of England MPC inflation forecasts for each quarter starting from Februry 2021 updated quarterly to May 2023. He said that the Bank resorts to event explanation for the overshoot in inflation. First it was Covid-19, then it was the furlough scheme, then it was Ukraine. Each of these are supposedly exogenous shocks but each updated forecast highlights the extent of the serially correlated forecast error of each previous forecast. Jamie Dannhauser said each was a different explanation, whereas it was much easier to explain it by fact that there is a lot of cash sloshing around. Tim Congdon said that the Bank cannot explain the movement of house prices with these exogenous cost type shocks, whereas broad money growth can. Philip Booth said that the Bank has been doing this for years. It is first surprised by inflation, then it tries to explain it by looking at individual cost components.

Market expectations of higher interest rates.

Jamie Dannhauser said that his observation of the forecast errors implied by the chart is that the Bank has finally acknowledged the flaws in the forecast and has factored in the existence of systematic inflation and has the risks around the most recent forecast skewed to the upside. He said that he expected that the August Report will show a further uplift in its baseline forecast. A further observation is that the markets have lost patience, and are now pricing in a substantial increase in Base rate with the 12-month OIS rate touching 6.5%.

Cost of living recession never materialised.

The UK composite PMI is back to normal levels after an initial dip and there has been a spectatcular rebound in consumer confidence. Jamie Dannhauser referred to recent experimental data produced by the ONS based on the entire population of the PAYE workforce.This has real time visibility of the labour force and is a good indicator of cycles in the real economy. This data is disaggregated to the 139 NUTS3 level. He said that in the past 3 months there has been a broadening out of labour market weakness which is the first sign he has seen of cracks appearing in the labour market. The data shows that the share of all NUTS3 regions in the UK where payroll employment has fallen in the last month. This data shows a spike of 90% in the lockdown period but has now moved up in the recent month. The data is useful as it plots the time path of the employment status and earnings of the same person over time.

Philip Booth asked if what Jamie Dannhauser was referring to as the first cracks in the jobs market, is really the labour market working more efficienctly than in the past and that is why we are not observing a labour market recession. Jamie Dannhauser said that the data suggests that people are moving around a lot more and regional mismatches are being smoothed.

UK Monetary and Credit Conditions

Real policy rate of 1% not enough?

On money, credit, and financial conditions, Jamie Dannhauser showed a chart of his best measure of the risk-free real rate of interest based on one-year ahead survey of inflation expectations measures. The chart showed that the real policy rate was about -4% before the hike in interest rates got going. On the latest figures, the real policy rate as of the OIS rate yesterday is about 1%. But he questioned if a 1% real policy rate is sufficient to bring core inflation down from where it is now - about 7%? In terms of broader credit conditions, there has been a small tightening, although credit conditions are better than last year. He said that bank lending rates have risen and some 90% of the stock of bank lending to corporates are floating rate which is in contrast to the US and the eurozone. The speed of the rise in interest rates to corporates has been meaningful.

Tim Congdon said that lending to the UK companies in the last year is down in nominal terms and lending to the UK financial institutions is down by a quarter. Lending on mortgages are ever so slightly up. He said that this is the effect of Basle 3 which has been punishing the banks since 2007, and altered the structure of bank lending to the UK private sector. Since September-October 2008 bank lending had started to fall. Jamie Dannhauser said that he agreed that post-GFC regulations had fundamentally changed the willingness of banks to lend to the UK economy.

Peter Warburton added that UK bank lending to fund management companies is down 30% from its peak. He was concerned that quantitative tightening was taking hold more broadly as global banks sought to reduce balance sheet risk. He said that there was something fundamental going on in the case of China. China was running a trade surplus of around $1 trillion a year and yet its foreign exchange reserves had not risen much. ~~are~~. A possible explanation is that they are exchanging the US dollars for RMB as ~~to~~ overborrowed Chinese corporate entities ~~to~~ repay $ loans to American, European, and possibly Japanese banks. These banks are strengthening their balance sheets rather than re-lending these repaid loans. So the banks are battening down ther hatches, consolidating balance sheets, and tightening lending conditions in the QT era. Jamie Dannhauser said that Peter Warburton's story is plausible in the European context but that the Fed has daily figures that show that lending to non-bank financial institutions is still growing.

Monetary policy biting less on mortgage market, but payment shock is coming.

Jamie Dannhauser said that one area that has received a lot media coverage is the mortgage market. He showed charts of the effective mortgage rate on the loan stock, the mean advertised effective rate on 75% LTVs, and the effective rate on new advances. He said the UK is no longer a floating rate mortgage market, and that the pass-through is slower with monetary policy biting less. He said that the market has moved from a 75-80% floating rate to under a fifth being floating rate. However, a payment shock is coming as the fixed-rate deals come off in mid-2024. A borrower coming off a fixed rate deal is going to be paying 400 basis points above the fixed rate. He said that he had some observations on this. First, there are far fewer mortgages in the UK than there used to be. Some 20-29% of households have mortgages now compared with 41-42% pre-GFC. Second, the quality of the borrowers is substantially higher. Third, the income and repayment capability of borrowers is much higher and most are dual earners. The payment shock for these households will be significant but he is puzzled by the alarmist nature of the commentary. He said that this was more a chronic headwind than an acute one, in his opinion.

Turning to monetary growth, Jamie Dannhauser said that the picture does not look dissimilar to the US, with broad money growth around zero per cent year-on-year. If adjusted in real terms the growth is negative. He said that his observation on the growth rate versus the stock is that the real money stock is shrinking rapidly and is now below the pre-Covid trend line.

UK Inflation Outlook

Grim inflation backdrop and falling food prices pass-through slow.

Jamie Dannhauser said that the data from the ASR UK inflation monitor shows a grim inflation backdrop. He said that imported price pressures are starting to ease with imported food prices falling rapidly but that the pass-through is slow. Britain appears to be paying a lot more for imported food than is consistent with world wholesale prices. He said that there may be a domestic margin story that explains this but he has no good explanation. There is some better news from upstream goods sectors but the inflationary die is now cast. He said that the UK real economy has done better than expected but the economy is growing slowly. Given the scale of monetary tightening, the risk of a recession is meaningful, but he questioned if this is going to be enough to contain the inflationary pressure.

Pay growth de-coupled from real

The labour market is extremely tight with vacancies still elevated but there has been too much focus on stock measures such as unemployment and not enough on flows of job-churn. He showed a chart that had pay growth in the private sector rising but voluntary job-to-job flows falling. He said that this was an indicator that inflation expectations are becoming de-anchored and nominal pay growth has become de-coupled from real indicators. Philip Booth questioned whether the indicator on pay growth should be real wages and job-churn rather than nominal pay growth. Jamie Dannhauser said that he was assuming some degree of money illusion.

Policy decision

Jamies Dannhauser summarised his presentation with the following points.

- The 'shock-cum-equilibrium' model that dominates central banking is a terrible way to set policy in practice.
- System dynamics are themselves endogenous to the shocks that strike the economy
- Degree of nominal momentum in the UK far out of proportion to 'real' developments or (lagged) direct impact of "exogenous" shocks
- Inflation psychology has changed
- MPC credibility has been damaged
- No option but to "over-tighten" now – and regain lost credibility
- Recession is coming, whether the MPC likes it or not; the question is what inflationary momentum there will be when it strikes
- Hike by 50bps; continue with QT

Discussion

Trevor Williams thanked Jamie Dannhauser for his presentation and invited comments from the committee.

Money tightness does not justify a further rise in Base rate.

Juan Castaneda thanked Jamie for a very thorough and comprehensive presentation. He said however that he was shocked by his policy recommendation. The chart of real broad money balances shows that it has fallen well below the pre-Covid trend showing a strong monetary contraction. He asked Jamie to explain how he could justify an increase in Base rate in these circumstances? Jamie Dannhauser said that while he places a large emphasis on monetary variables, they are not the sole determinant of inflation and nominal momentum. He said that the monetary overhang in nominal terms is still pretty sizeable. He said that the scale and duration of inflation running well above 2% has created a change in the psychology of inflation. While that might sound nebulous, it was not obvious to him that it could be remedied by hoping that the monetary tightening to date has done enough. He said that he had no doubts that the sharp slow-down in monetary growth will cause a recession and has the potential to reduce inflation but he did not think it will be enough. In terms of risk management he said that there is a case for over-doing it. Juan Castaneda thanked Jamie for his answer and said that he did not agree with Jamie's policy recommendation but he understood his rationale.

Inflation psychology has changed … case for overdoing monetary tightening.

Monetary tightening is showing up in the real sector. No reason for a panic

Trevor Williams asked Patrick Minford for his comment as he had to leave the meeting. Patrick Minford said that he appreciated what Jamie Dannhauser has presented and that it was a very good survey. He said that the policy recommendation is wrong. There has been considerable monetary tightening but also the labour market figures produced by Jamie showed a weakening going on. He said that he expected nominal wages to exhibit a catch-up with inflation as Phillip Booth mentioned there is a real wage equilibrium. There is quite a lot of evidence of substantial tightening. He said that he would not be in favour of a panic response. Inflation is coming down slower than expected because there is a lot of variablility around the lags in response. There is a danger of over-reacting to the disappointment with the pace at which inflation is falling. Getting inflation down from these very high levels is going to be a long and slow process. It is turning out to be slower than expected. The dangers of overtightening are substantial not just to the economy but also sparking a financial crisis. He said that he is in support of Base rates slowing down in the rise and basically coming down. He said that he is against any Quantitative Tightening given the dangerous state of the Gilts market.

Fiscal not monetary policy should be tightened.

Trevor Williams thanked Patrick for his comments and asked if Peter Warburton would like to comment. Peter Warburton said that he is in the same camp as Patrick Minford. His observation is that there is a very loose fiscal policy and the government is losing its grip on public finances. A corrollary of loose fiscal policy is the amazing growth in corporate profitability. The tightening needs to be fiscal tightening and not monetary tightening. He said that he had blogged about banks going rogue and failing to transmit monetary policy in a predictable way right now and that their risk management is working against the health of the UK economy. They are amplifying the tightening stance of the Bank of England. He said that there should be no increase in Bank rate and a bias to cut but not at this point and that QT should be curtailed.

Trevor Williams brought the discussion to an end and asked that members indicate their votes. Jamie Dannhauser had indicated his vote in the summary of the presentation.

Votes

Votes are recorded in the order they were given.

Comment by Jamie Dannhauser

(Ruffer LLP)
Vote: To raise Bank Rate by 50bps. Maintain QT.
Bias: No bias.

Jamie Dannhauser said that the inflation psychology of the economy had changed and that there was no option but to over-tighten now to regain lost credibility. He voted to raise bank rate immediately by 50 bps and to maintain the pace of QT.

Comment by Peter Warburton

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

Peter Warburton said that the tightening should be with fiscal policy and not monetary policy. He voted to hold Bank rate and to curtail QT.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To hold Bank Rate. Curtail QT.
Bias: to cut Base rate over time.

Patrick Minford said that there was a danger of over-reacting and over-tightening monetary policy. Inflation was on the way down and it may not have fallen as fast as we would like but to raise rates would damage the economy and possibly prompt another financial crisis.

Comment by Juan Castaneda

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

Annualised money growth is negative.

Juan Castaneda said that his vote will be much the same as the previous meeting He said that the annualised rate of growth of broad money in the UK in the past three months is contracting. While the annual rate is 1.5-1.6%, the annualised rate for the last 3 months is in negative territory. If this continues the current monetary contraction will show up in strong disinflationary pressure. He said that he did not see the point of the last increase in Base rate by the Bank of England. He did not see any reason to increase Bank rate. He said there should be a stop on QT.

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)
Vote: No change and to control broad money growth
Bias: No bias.

Money growth must be low and stable in two years.

Tim Congdon said that his view is to look to the medium term with broad money growth to be in the range of 2-5% to produce a target inflation rate of 2% looking ahead to 2025-2026. He said that public finances should get back to sustainability in two to three years from now. In that context money is falling and there is no doubt that the banks must be worried about further increases in capital requirements. He said that he was not in favour of raising Bank rate now. There should be a clear strategy to bring the budget back into balance in three to four years. Monetary growth should be low and stable in say two years.

Comment by Philip Booth

(St Marys University)
Vote: To hold Bank Rate. Discontinue QT.
Bias: No bias.

Wage-price spiral can be sustained only by monetary accommodation.

Philip Booth thanked Jamie Dannhauser for a very well-presented case, but he disagreed with his policy recommendation. He said that it would be good if the Bank of England had some disagreement at their meetings. He said that he was worried about inflation and inflation expectations getting embedded. However, we should look at monetary growth figures and, if they suggest inflation will fall, not lose our nerve just because it appears stubborn in the short term. In relation to the credibility issues Jamie Dannhauser raised and for the potential for inflation to get embedded in a wage-price spiral, this can only happen if validated by monetary policy. He said that fiscal policy has no bearing on inflation. He said that he was going to keep his nerve and keep Base rate on hold and hold QT.

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: To hold Base rate. Temporary end to Quantitative Tightening.

Bias: To cut bank rate

Monetary policy is ineffective against real shocks.

Trevor Williams thanked Jamie Dannhauser for a comprehensive analysis. He said that most of the rise in inflation was due to the supply-side shock from the invasion of Ukraine, and it is false to think that the Bank could use monetary policy on its own to deal with it. The risk of overtightening stems from believing that inflation will fall if you slow demand, ignoring its causes and the reality of negligible UK growth. Take another supply-side issue - the shortage of workers and the demographic profile of the economy – monetary policy alone cannot solve that either. The working-age population is on a declining trend. So which jobs would have to go for unemployment to rise and validate the view that monetary policy is too loose without its rise? He said that negative growth in money supply is a signal of policy being overdone. The Bank should hold its nerve and wait for the supply-side effects of a significant reversal in commodity prices, the effects of the rise in inflation last year to fall out of annual comparisons, slowing demand and its rate rises so far to work through the economy. He said he voted for a hold on the Bank rate and to end QT for now.

Comment by Kent Matthews

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

If inflation expectations are adaptive, wage growth would be higher.

Kent Matthews said that he agreed with the majority policy prescription but that he approached it from an entirely different place. He said that he was impressed by Jamie Dannhauser's presentation and particularly his estimate of the real policy rate being about 1%. This means that inflation expectations are in the region of 4% 12 months ahead, which sounds about right. While Jamie Dannhauser made the point that the inflation expectations was based on surveys of households, he said that a recent paper by Ricardo Reis published in the 2023 AEA papers and proceedings shows that household inflation expectations are no worse than other survey measures. He said that as a fan of the late Bob Lucas he saw no reason to give up on rational expectations and draw on notions of market psychology of inflation. If the world was adaptive expectations, then wage inflation would be higher than current price inflation as inflation has started to recede, but the fact that real wages have fallen means that people recognise that there has been a supply shock that will result in a fall in equilibrium real wages in the long run. Similarly, the expectations of a downward shift in real output from the supply shock will lead to a fall in the demand for real balances which has happened according to the data. He said that there was a link between the budget deficit and inflation, and it all depended on expected financing, and the gap between the real rate of interest and equilibrium growth rate. In conclusion, the economy is close to an equilibrium and there is no reason to increase interest rates. He voted for a hold in Bank Rate and to stop QT.

Comment by Andrew Lilico (in absentia)

(Europe Economics)
Vote: Hold
Bias: Bias to hold

Any other business

There was no other business, and the meeting was closed.

Policy response

1. On a majority of eight to one the committee voted to keep the Bank rate on hold.
2. There was an overwhelming majority to halt or reduce the pace of QT.
3. One member voted to raise Base rate by 50 bps and continue with QT.

Date of next meeting

10 October 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).