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THE NEW GREAT INFLATION

How western Central Banks got it wrong ...and what they should do about it

John Redwood

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About the author

Sir John Redwood is the author of the daily commentary site www.johnredwood.com. A Distinguished Fellow of All Souls College, Oxford he has been a Cabinet Minister and Shadow Cabinet Minister, the chairman of a public listed industrial group, the co-founder of an investment management business and written many newspaper articles. He has published widely on economics and politics including 'Popular Capitalism', a book on wider ownership, 'We Don't Believe You', a book on populist movements, and 'Our Currency, Our Country', on keeping the pound. He is the Conservative MP for Wokingham.

This IEA Special Edition is based on a lecture first given by the author at All Soul's College, Oxford, in May 2023.

Introduction

In the period 2020-23 the world has witnessed a revival of inflation in the USA, UK and Euro area. After the banking crash and great recession of 2007-2009, the West enjoyed a period of low inflation and low interest rates with modest growth. China continued a period of sustained high growth as it sought to reduce the gap in living standards and investment with the advanced economies, whilst Japan continued its post-1989 crash experience of no inflation, zero interest rates and slow growth. This paper asks why inflation picked up sharply in the West in the last three years whilst staying low in China and Japan. What can the central banks of the USA, UK and Euro area learn, if anything, from the central banks of countries that kept inflation down despite global energy, food and commodity price surges? Why did the western central banks get their inflation forecasts so wrong? Why did their policies lurch from very, very accommodative to much tighter once inflation had gone up? Why has there been relatively little criticism of them for failing to carry out their remits to keep inflation to around 2 per cent? What role should central banks play in controlling prices and promoting growth? Are they truly independent, and does independence secure good results? Is all political interference in these matters unhelpful, as some would imply? Why did some countries with central banks acting expressly as the arm of the government do better?

The chosen countries

I decided to analyse the results in the USA, China, the Euro area and Japan, as the four largest economies in the world, and to include the UK. The UK is the fifth or sixth largest economy in the world and has one of the world's largest currency and financial asset marketplaces. It also happens to be the country I know best and worry about the most. The Bank of England (BoE), with some overhang from sterling area days, is a major central bank with influence well beyond London. The Federal Reserve Board in the USA, the People's Bank of China, the Bank of Japan, the European Central Bank (ECB) and the Bank of England are together very influential in world markets, helping to form the daily prices of main currencies and bonds and accounting for more than 60 per cent of the world's $100 trillion GDP. The governors of the western central banks and Japan have influence through the finance meetings of the G7, G20 and other international forums.

Inflation – the targets and the record

Table 1: Inflation, Consumer Price Index 2020-2023

Year	UK	Euro area	US	China	Japan
2020	1.0%	0.3%	1.2%	2.4%	(0.03%)
2021	2.5%	2.5%	4.7%	0.9%	(0.2%)
2022	7.9%	8.3%	8.0%	2.0%	2.5%
2023 (May)	7.9%	6.1%	4.0%	0.2%	3.2%

Sources: ONS (2023), European Central Bank (2023) and The World Bank (2023)

Each of the five central banks has as its main objective creating price stability. In each case, this is, in practical terms, defined as allowing average prices to rise by around 2 per cent each year as measured by the Consumer Price Index. (The Federal Reserve is distinguished in not having control of inflation as the only overriding objective, needing to balance it with growth.) Countries are encouraged to use harmonised indices, though there is national discretion over choosing baskets of goods and services to monitor prices in line with national purchasing tastes. Table 1 shows that in the last four years China and Japan have kept price rises below 3 per cent, close to the 2 per cent target, whilst the western trio has seen prices rise well above target. Japan has seen inflation rise to a headline figure of 4 per cent in December 2022, though core inflation has remained below 2 per cent, reflecting energy and food rises globally.

China has managed to keep its inflation down and has made use of price and supply interventions. The UK and EU have also managed prices and intervened in supply. The UK and Euro figures appear flatter, as both experienced sharp surges, with Eurozone inflation going well above 10 per cent in several countries. UK inflation stayed higher for longer in 2023, partly because energy price controls delayed energy price falls and partly because the UK follows a dear energy policy as part of its approach to net zero. In all three western economies, the labour market stayed tight in 2022-2023 with wages drifting up, but in each case, wages lagged prices by a substantial margin. Governments offset some of the hit to real incomes, particularly for lower-paid people with benefits, minimum wage rises and special energy subsidies and price controls.

The central banks' interest rate response

Table 2: Central bank interest rates 2020-2023

Year	UK	Euro area	US	China	Japan
2020	0.1%	0%	0.25%	3.85%	(0.1%)
2021	0.25%	0%	0.25%	3.8%	(0.1%)
2022	3.5%	2.5%	4.5%	3.65%	(0.1%)
2023 (May)	4.5%	3.75%	5.25%	3.65%	(0.1%)

Sources: BoE (n.d.), ECB (n.d.), Trading Economics (US, n.d.), People's Bank of China (n.d.) and Trading Economics (Japan, n.d.)

Note: Rates for 2020, 2021 and 2022 are the end-of-year figures.

In 2020, the BoE, ECB and Fed responded to government policy decisions to lock down large parts of their economies by taking interest rates to near zero. The Fed led the reductions in March 2020, when bond and share markets were in freefall and many were alarmed by what might happen with the sudden collapse of many businesses unable to trade. The governments responded at the same time with large programmes of financial assistance to companies that lost turnover and individuals who lost their jobs and incomes. These payments could be financed by borrowing by governments at zero interest rates. The Bank of Japan continued with its yield curve control policy, aiming to keep the ten-year rate of interest at zero with negative shorter rates. The People's Bank of China, despite lockdowns, kept its interest rate a bit below 4 per cent. The longer-term

interest rates determined by the price of government bonds and their yields in the US and UK collapsed to very low levels, and in the case of German ones they went negative, just as Japanese rates from 1 to 10 years were already negative before COVID.

In 2021, the US, UK and Europe were coming out of lockdowns and enjoying economic recoveries. It is true that there were relapses caused by COVID flare-ups, with different timetables for the different countries. The Fed and ECB kept rates ultra low throughout that year, whilst the BoE started to edge them up as inflation was rising quickly. In 2022, when it became even more obvious that inflation was a major problem in the western economies, the Fed, the BoE and the ECB hiked rates aggressively in a series of individual rate rise decisions across the year, reaching 4.25 per cent in the UK, 3.25 per cent in the Euro area and 4.5 per cent to 4.75 per cent in the USA. China increased rates in 2022 and reduced them in 2023 by modest amounts, and Japan kept her rates around zero throughout.

The central banks buying and selling bonds

The leading western central banks had adopted the policy of quantitative easing (QE) in response to the monetary and banking disaster of the Great Crash of 2007-2009. Japan had pioneered it following its even bigger crash in 1989-1990. Quantitative easing entails the Central Bank using its power to create money to put money into an account at the bank to buy up bonds in the market. The western banks mainly bought government bonds issued by the governments they act for. There was smaller scale buying of the bonds of large corporations and, in the case of Japan, some index funds of shares and property investment trusts. The idea of buying the government bonds was to inflate their prices, as the higher price of the bonds produces a lower rate of interest. The typical government bond offers a fixed amount of income every year so if someone pays more for the bond, the fixed income paid becomes a smaller percentage of the value of the bond. As bond prices rise so the government can borrow more by issuing new bonds where they offer less interest per pound of borrowing than before.

The Central Bank ends up financing the bonds it buys by accepting deposits from commercial banks as so-called reserves. If someone sells a bond to the Central Bank under a QE purchase programme, they will be paid cash by the Central Bank in the form of a deposit at their bank. If they subsequently spend the money on something else, that money will be re-deposited by the person they are paying.

Commercial banks that, as a result of QE, end up with more deposits are then freer to lend more money out to customers. This is because their lending is in part controlled by the need to keep enough cash to be able to pay out depositors who want their money back. As the bank has lent a

lot of the money out longer term it needs enough cash for those who want to withdraw their cash at any given time. The first aim of QE is to get interest rates down. The secondary aims are to let the government borrow more money more cheaply and allow the commercial banks to lend more money out to get the economy moving faster. Japan has been trying this for many years. It has succeeded in allowing the government to build a vast debt and spend more than it otherwise could, but it has been less successful in triggering fast private-sector-led growth from more credit. Japan did not change its approach to QE as a result of COVID. In western countries, such policy seems to boost consumer and corporate spending much more.

The Fed, BoE and ECB undertook substantial QE in the years 2020-2022. China undertook none and Japan continued as before with its QE. In 2022-2023 the three western banks switched from QE to quantitative tightening (QT). QT is the reverse process. Mild QT entails the central banks allowing bonds they own to be paid back on maturity without reinvesting the proceeds in more bonds as they do when they are following a QE policy. They typically buy a range of bonds from one year to longer duration, with up to 30 years or more before they repay. They have to manage these portfolios as bonds fall due. Tough QT entails selling bonds back through the market to new buyers before they mature. Simply failing to reinvest the proceeds from the repayment of bonds should lower bond prices a bit and raise rates a bit, as during QE programmes banks are a big force in the market, deliberately buying badly to drive prices up. Adding direct sales into the market should depress prices more and more rapidly on announcement of the sales programmes, as indeed has happened. Ten-year yields have rushed through 4 per cent in the UK and USA on the back of aggressive QT programmes.

The central banks' balance sheets expand and contract by large numbers

In August 2019, the Fed's balance sheet was $3.759 trillion. By April 2021 it had reached a peak of $8.965 trillion as a result of massive bond purchases and financial relief for the banking system. The QT programme had taken $626 billion off the balance sheet by March 2023. The loss of two regional banks led the Fed to put $400 billion back into banking markets, expanding the balance sheet again. It is now falling as the QT programme proceeds.

The BoE balance sheet stands at £1.05 trillion. They added £895 billion to it through the various QE programmes from the great banking crash of 2007-2008 onwards. The COVID period accounted for the larger share of this at an extra £450 billion. The BoE is now seeking to reduce the bond portfolio by £80 billion a year. When it triggered a bond meltdown thanks to pension-fund-levered holdings of bonds in the autumn of 2022, the BoE temporarily reversed the QT policy. This was the 'LDI crisis', and the BoE briefly went back to buying government bonds to reverse the falls, which duly reversed quickly on the news.

The ECB has expanded its balance sheet to 7.7 trillion euros. It added 3.32 trillion euros of bonds under its Asset Purchase Programme and 1.71 trillion euros under its Pandemic Purchase Programme. It has recently begun a modest programme of QT and is not in the same hurry to cut its balance sheet as the Fed and BoE. The Bank of Japan has continued to expand its balance sheet. The People's Bank of China has argued strongly against such measures and has not gone in for a large expansion to offset COVID lockdowns.

Does quantitative tightening create financial market instability?

The US saw two large regional banks go under when they experienced runs by depositors. Silicon Valley Bank lost depositors because they feared the bank had lost too much money holding a portfolio of government bonds. These bonds had fallen a lot in price because the Fed had raised rates and sold a large quantity of bonds to push their prices down. In this sense the banking disruption was a fallout related to QT. In the UK the LDI crisis saw pension funds having to sell government bonds because they owned too many through funds that allowed them to own more than they could afford to pay for. They bought them by paying a proportion of their full price, with a promise to top up what they paid if the bonds fell in value. When the BoE announced a major programme of bond sales and signalled rates had to go up, the bonds fell in value. An expansionary budget followed, so the bonds fell a bit more on that news. The BoE recognised its error in its action by immediately reversing QT and announcing a new short programme of QE bond buying. This was targeted at pension funds and duty-stabilised bonds for a bit. When the BoE resumed full QT, bonds sold off again.

The ECB, which has only just started QT, and Japan and China with no QT have not experienced similar problems. It is of course quite possible to have banking crashes without a central bank QT or major rate rises. Switzerland experienced the collapse of Credit Suisse, and China presided over the collapse of highly leveraged property companies in recent years.

Money and credit

In March 2020 with markets tumbling, fear stalked the financial world. Investors wanted to pull money out of shares as they feared mass bankruptcies with companies no longer allowed to open to trade. They feared governments would be unable to meet all their greatly increased bills with tax revenues drying up as people kept away from shops and factories stopped making many things. Even US Treasury bonds, the ultimate safe asset, dropped sharply. The Fed made a dramatic announcement that it would make $3 trillion dollars available in various ways to return cash to markets to allow the government to borrow to spend and to get more money circulating despite the absence of work and earned incomes for all too many people. The other western governments and central banks followed suit with large programmes of support for markets, people and companies. Quantitative easing led to ultra- low interest rates. Heavy state borrowings and big spending were unleashed, and markets rose sharply as a result.

M2, a standard measure of the quantity of money, soared in the USA, rising from a money supply of a little over $15 trillion in January 2020 to a peak of nearly $22 trillion just two years later, an astonishing rise of around 40 per cent. In the UK M3 money soared from £2.9 trillion in January 2020 to a peak of £3.7 trillion in the autumn of 2022, a rise of 27 per cent. The ECB took Euro area money up from 12.5 trillion euros in early 2020 to a peak of 15.5 trillion euros in autumn 2022, a rise of a quarter. China continued with a steady climb in money around its target of keeping money growth in line with nominal GDP. Chinese money growth has always been a lot faster than western growth since this is needed to accommodate much faster economic growth and the rate of climb did not change over the COVID period. Japanese money growth was a more restrained 15 per cent 2020 to 2023.

Japan, with an elderly population and high propensity to save, has not converted low interest rates and QE into big increases in borrowing and activity over the years of her programmes. Only the government has expanded, borrowing a lot, and spent a lot. With borrowings at zero interest rate, it has been easily affordable, and with the state-owned Bank of Japan owning half the bonds in issue now as a result of QE, the Japanese state can continue to control its strange finances. Were it to ever need to put its interest rates up materially, the Bank would incur huge losses, and the state would have to rein in the deficit quickly.

How independent are these banks?

It is commonly argued that the three western central banks are 'independent'. On any account, 'independence' would come in many forms and may be described in various ways. However, the general idea is clear. What is not clear is that it has much reality. In the case of the People's Bank of China, it is an arm of the state. It aims to implement policies based on the strategy and aims of the president of China, President Xi, and in accordance with the policy requirements of the Politburo and Central Committee. It has the scope to make decisions about interest rates, its balance sheet, transactions in markets and other financial matters, as do the western banks, but always sets its actions in the context of the wider aims and economic policies of the government. The Bank of Japan works closely with the Japanese Treasury and with the instructions of the government. Its loose-money policy has been an important part of Japanese economic policy, expressly recognised as part of Prime Minister Abe's three arrows policy (of 2012) where it was a crucial one of the arrows.

Three of the five banks are 100 per cent owned by the state. The ECB is owned by the member states' central banks, which in turn are owned by their states. In all five, the governor or executive head of the bank is appointed on the proposal of the government, with or without endorsement by parliament or congress. The balance sheet of all five is an integral part of state finances and all five would look to the state for additional capital if the need arose. QE profits may be given to the states that lie behind them. This is not the normal structure of independent bodies. The Fed expressly has a twin mandate when it has to balance curbing price rises with growing employment. Politicians often intervene with views on the balance of these two crucial features of general economic policy and often legislate to further one or other of the aims. The Fed needs to listen and

respond. These banks have to account for their actions to the government of China, to the parliaments of the EU, UK and Japan, and to Congress.

In the case of the BoE, the policy of quantitative easing, and therefore, by extension, quantitative tightening, is a dual control policy where the Bank needs to get the approval of the Chancellor of the Exchequer and receives a Treasury guarantee to pay any losses the BoE may incur from buying and selling the bonds. Its website makes it clear that the Bank undertakes QE and QT as an agent of the Treasury. In the case of the ECB, the losses and profits of QE and QT are shared between the ECB and the member states' central banks. Eighty per cent belongs to the member states, which usually pass the money on to their Treasuries.

When President Biden took over from President Trump, the two senior vice chairmen of the Fed retired early. Leading Democrats were appointed in their place with different views and priorities than the men they replaced. The Chairman, a Trump appointee, was reappointed after a public consideration of changing personnel. The reappointed chairman made it clear that he supported the economic priorities of the new Administration, as he needed to do. The ECB is a custodian of the drive towards EU integration. Set up under the Treaties, it will, as President Draghi once memorably said 'do what it takes' to secure the future of the euro and progress towards greater financial and monetary union.

The central banks are clearly not independent when it comes to setting policy objectives. They respond to informal and formal changes to their remit from governments. There have also been important times when even their relative independence to set interest rates has been overruled. In the middle of the great banking crash, finance ministers came together to demand a concerted interest rate cut to avoid further mayhem in markets. The central banks all complied, with the BoE convening a special out-of-sequence Monetary Policy Committee meeting to put through a rate cut, claiming they did so out of their independent judgement. The German Central Bank, the role model for independent central banks in the second half of the last century, famously was overriden when it came to the crucial decision about how to integrate the Ostmark with the DM. It was overridden again with the decision to scrap the DM and join the euro. These two events were fundamental to German monetary policy, and both proved inflationary.

The Chinese critique of the Fed and ECB

In a recent monetary report, the People's Bank celebrated its relative success in keeping inflation down and avoiding banking or bond market turbulence. It stated that 'instead of following the Fed's policy, we avoid great volatility in releasing or draining liquidity, and do not advocate competitive zero interest rates or quantitative easing'[1] that bring about asset bubbles, excessive investment or debt escalation. For some time, they have been sceptical of the special measures taken in the West by central banks to stimulate activity. The People's Bank has of course its own past experience of property and lending bubbles, with a lot of debt-driven growth.

The People's Bank has a policy aim to keep the size of its balance sheet stable to avoid inflation and to maintain financial strength to be able to act as a lender of last resort. This is an important view, implying that if the western banks got very weakened balance sheets with large bond losses, they would somehow be impaired when they needed to lend money to stressed commercial banks. The Fed would disagree, believing it can function with a weak or negative asset balance sheet if necessary. Maybe the Fed, as custodian of the world's reserve currency, is in a stronger position than the other central banks, which may need to be more careful about the strength of their own finances. The BoE will keep its balance sheet strong with Treasury payments for losses.

1 'Global Financial Cycle: Trends and Implications—Keynote Speech', Pan Gongsheng at the 14th Lujiazui Forum, 8 June 2023 (http://www.pbc.gov.cn/en/3688110/3688175/4964358/index.html)

The Chinese note that they held meetings to analyse money and the credit situation. They have a target to keep money growth in line with nominal GDP growth, with a view to keeping inflation to 2 per cent which they have done in recent years. They highlight the much greater growth of the Fed's balance sheet in the last three years compared to the Chinese experience.

The People's Bank has been handling complex problems with an overheated property sector, which the government wished to cool and partially nationalise, and with weak commercial banks, where capital reconstructions occur when needed.

The western banks defence

They claim their independence is important to keep focusing on cutting inflation now that it has risen. They blame a variety of other factors for the inflation they did not see coming.

Their defence that the inflation was mainly caused by an energy price surge brought on by the Ukraine war, which they could not forecast, does not explain why inflation was already well over target and rising before the invasion. It does not explain why some other countries faced with big energy price rises did not experience much of a rise in overall inflation. They do not tell us why there is now a general inflation whilst energy prices have lost most of the gains they made during the early months of the war.

Their defence that current inflation is caused by rising food prices brought on by bad weather or war disruptions to some crops is even less convincing. Again, there are food-importing countries with much lower overall inflation. Western inflation took off before the food price surge.

They defend continuing with massive QE in 2021 on the grounds that inflation was low and they could not cut rates more once they were at zero. Technically this is wrong as they could set negative rates. More importantly, why were they looking back at low past inflation and not looking forward to see the inflation coming? Why did they want to cut rates when the enemy was inflation?

The BoE's defence for aggressive quantitative tightening is that it does not have much impact on inflation or the general economy. They seem to misjudge the impact it has on bond markets, which in turn drives up mortgage rates and damages output considerably.

Why did the three central banks get their inflation forecasts so wrong?

The errant three have similar complex models of the economy to help them forecast future inflation. Inflation in two years' time is the crucial figure they study to decide rates and bond transactions, as they believe money policy takes time to take effect, so they need to move to tighten or loosen early before inflation or a recession kick in. In practice, they run the danger of responding to figures published about past outcomes instead of retaining focus on what is likely to happen two years from now. Central banks have a tendency to tighten after inflation is high and tighten too much for too long, causing a recession. In a recession they are slow to relax rates and then carry on doing so for longer than is wise.

Their models do not take the issues of money growth and credit seriously. The Fed and BoE do not report on money growth and discuss what it means for the economy and for policy. They prefer to concentrate on the concept of capacity, seeking to judge whether the economy is running hot or cold and whether interest rates need to promote more output and employment to take up the slack or less to cool the markets.

Capacity is a very difficult thing to calculate. A company may only find out how much extra capacity it can create when it faces a large order. Then it needs to see if it can work extra shifts, if it can easily hire more labour and if its suppliers can readily send more raw materials and components or not. The banks tend to concentrate on the labour side of capacity and see unemployment or employment as proxies for capacity. This is misleading in a world where there can be high degrees of mechanisation in industry and where the availability of raw materials and components may often be a bigger constraint than labour.

They also tend to have a national rather than global view of capacity. In reality, an open economy such as the UK or US has the option of importing when its own factories are running flat out or its own farms cannot in the short term grow more. As soon as anyone tries to model the ability to import, the concept of capacity becomes difficult to use to determine national interest rates to achieve the right inflation outcome.

The banks themselves, who know the details of their models much better than outsiders, should be asked to reprogramme their models to get them closer to outturns. Now that they have a good run of twenty years of numbers where they have got their forecasts wrong, especially at the big turning points, they need to alter things until they can get a better fit. I doubt they can do this without a stronger role for money and credit in the models.

Why did the three western central banks want to lose so much money on bonds?

I assume the intelligent and financially literate, well-paid experts who presided over bank policy during the QE years all understood that they were deliberately buying bonds at very inflated prices with a view to making losses. They often bought these bonds at prices higher than the repayment value – buying above par, as they say. If they bought a bond at £120 per nominal £100 because they wanted long rates materially lower than when the bond had been issued by the government, they would expect a loss of £20 when it finally matured. They have now decided they want to sell some of these bonds below the repayment level, increasing the losses by more. There are various official calculations of the possible losses, with the UK sure to lose more than £100 billion on bond holdings and the ECB and Fed proportionately more given the much larger sizes of their portfolios. It is a curious thing to have wanted to do.

If a central bank intervenes in the foreign exchange market, it is usually because they think their national currency has fallen too far. By buying it they both hope to send it up a bit and make a profit. Yet here we have a clear case of intervening wanting to lose money, knowing that one day they would need to put rates up, and this would send the bonds they bought plunging in value. The Fed has the best but most cavalier reply, saying they do not worry if they lose a lot of money as they live with a balance sheet that simply records the losses and lets them trade with negative capital. The BoE was so worried about the likelihood of large losses trashing its balance sheet that it made taxpayers and the Treasury agree to repay every pound they lost to preserve the bank's capital. The ECB is taking fewer large losses prematurely and is looking to the national

central banks to make up much of the damage when it has used up its own provisions.

It is not helpful for central banks that they will have to report a succession of large losses and will need to answer questions about the adequacy of their capital and how it is to be rebuilt. It looks as if the central banks had not thought through all the presentational issues with these losses and underestimated the impact on the real economy of accelerating disposals with a view to increasing the losses needlessly.

Conclusions

The Euro area, USA and UK are suffering from excessive inflation primarily due to bad errors by their central banks. Deliberately inflating asset prices through QE to offset the effects of lockdowns, these banks continued with excessive monetary expansion throughout 2021 leading to high inflation in 2022 as the extra money moved beyond the inflated asset markets for bonds, shares and property into buying goods and services and expanding bank credit. A good case could be made for the initial QE to offset lockdown shocks, but not for the further QE well into recovery. The central banks persisted with forecasting low inflation until it was high and then forecast transitory inflation when it was setting in and spreading to wages and services. The war in Ukraine led to energy price spikes and temporary grain price surges, but some large economies and countries avoided this pushing their inflation much above 2 per cent, showing that central bank policy could make a difference.

The poor performance of the central banks at forecasting inflation and the consequent policy mistakes they made based on bad estimates should lead to a review of their models, forecasting and policy recommendations. There needs to be a greater understanding of the limits the constitutions of the UK, USA and Euro area/EU place on their central banks and better working between Treasuries and Central Banks. Treasuries have to accept some responsibility for controlling inflation whilst central banks have to balance the needs of growth alongside the imperative to control prices. This is expressly set out in the US mandate to the Fed.

It is not for me to tell the USA and the Fed how to behave or to lecture the EU on the performance of the ECB. I do have advice for the BoE and the UK government on how we could avoid such a disaster in the future, now that the UK has been reminded that allowing inflation to take hold is a bad idea.

Recommendations to the UK government

The government should ask the BoE to review its forecasting and models and request that it make amendments to improve its forecasting abilities, especially for inflation.

The government should adopt the 2 per cent inflation target it places on the Bank as its own economic target as well and should manage public services and finances with controlling inflation in mind. It should add a 2 per cent growth target to the Bank and to itself, so like the US Fed, the BoE expressly needs to balance output and inflation in its policy response.

The government should cut back on excess spending, which has risen by more than £300 billion a year since 2019. I have written about many proposals for lower spending that would not damage core services such as the NHS and education. The government needs to embark on a major set of initiatives to boost productivity and quality for the money spent throughout the public sector as part of its contribution to getting inflation down. It needs to move away from the high tax, high subsidy model. It should move more towards a well-paid, more productive public sector workforce. It should freeze recruitment of additional people overall whilst allowing expansion in shortage areas such as medical professionals and teachers.

The government should change the remuneration packages for new or promoted senior BoE staff and members of the Monetary Policy Committee. In order to earn a high income, they should need to earn a bonus based on their success in forecasting and controlling inflation on top of a more modest base salary.

Recommendations to the Bank of England

The BoE should immediately conduct an internal review of its models and forecasting, to find out why it got inflation so wrong and to propose amendments that would have produced better outcomes. It should back-test changes to the model to make sure they result in material improvements.

The BoE should produce an analysis of the role of money and credit in inflation and discuss how this can be monitored and used to help make policy decisions about rates and money creation going forward.

The BoE should ensure in its future recruitment to senior roles on the staff and to external appointments on its committee that it appoints to obtain a greater diversity of views about economics and inflation. It should wish to have representatives of the main strands of economic thought on the important topics around the table.

The BoE should reward staff when it hits targets for accuracy of forecasts and success of outturns in policy decisions.

The BoE should reconsider its attitude towards quantitative tightening. If it is unimportant as an influence on inflation, as it says, and the purpose is technical or tidying up, it should stop selling bonds and let maturities gradually reduce its balance sheet. It should consider whether its bond sales do depress markets in ways that can disrupt them, consider the flow across to its tasks in maintaining banking sector stability and ask whether too many bond sales might make a recession more likely.

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The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
email iea@iea.org.uk