Shadow Monetary Policy Committee

17 October 2023

Shadow Monetary Policy Committee votes seven to two to cut Bank rate

After voting by 8-2 to hold the Bank rate at its last meeting in July, the Shadow Monetary Policy Committee has voted by a margin of seven to two to cut Bank rates at its October meeting ahead of the actual MPC meeting in early November. Six members wanted an immediate cut of 0.25% to 5%, eight of the nine members wanted quantitative tightening (QT) to be halted or scaled back, and one member wanted to restart quantitative loosening (QE).

There was widespread concern that the evidence was mounting of an undershoot of the inflation target over the next few years with the risk of recession as indicated by negative growth in broad money.

To reinforce that concern, after the meeting had ended, September figures showed an even sharper fall was occurring in annual M4 growth. Members were convinced that - on unchanged interest rates - not only would inflation fall below target over the next two years, but there was a strong likelihood that it would turn negative. To avoid that outcome, a large majority wanted an immediate cut in interest rates despite the current financial market expectation of unchanged rates until Q4 of 2024.

There was a widespread view that the contraction in money supply was accelerating because of too tight market conditions and too much QT. One member noted that QE might be required to calm financial markets and that market rates were too high given the economic conditions facing the economy and the long-term likelihood of inflation declining.

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, distinguishing 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. That can change 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 17 October 2023 Institute of Economic Affairs (hybrid meeting)

Attendance: Roger Bootle, John Greenwood**,** Julian Jessop, Graeme Leach**,** Andrew Lilico, Kent Matthews (Secretary – online), Patrick Minford (online), Trevor Williams (Chair).

Apologies: Peter Warburton, Timothy Congdon, Philip Booth, Juan Castaneda

Chairman's comments: Trevor Williams opened the hybrid meeting and invited Andrew Lilico to provide his analysis of the global and domestic economic environment.

World Indicators

Third inflation wave premature

Andrew Lilico said that he would begin with some world figures and present charts on OECD leading indicators. He said the indicators were negative until mid-year but have turned slightly positive in September 2023 except for the USA which is marginally negative. Andrew referred to an article in the *Daily Telegraph* that talked about a third inflation wave. He said that oil prices have risen recently because of the Middle Eastern war but with oil prices rising to $90 a barrel, talk of a third wave is premature. Oil prices are still well down on the mid-2022 peaks.

OECD M3 growth negative in 2023

Andrew Lilico said that the most critical world monetary indicators are the movements in global interest rates and broad money supply. He said that interest rate normalization has arguably occurred in the USA with 10-year Treasury yields touching 5%. But OECD broad money growth has collapsed showing negative growth in the middle of the year.

UK Economy

GDP is flirting with recession… unemployment low but ticked up recently.

Turning to the UK, Andrew Lilico referred to charts of year-on-year and quarter-on-quarter GDP growth rates and concluded that GDP is flirting with contraction but was not there yet. The Bank of England is forecasting steady but unspectacuar growth for as far as the eye can see. Unemployment remains very low but has ticked up in recent months to its highest pre-Covid level since 2017. Trevor Williams raised the question if the Bank had done any work on their GDP forecasting performance given the change in the interest rate environment. Andrew Lilico said that quite a lot of recent work has gone into the inflation forecast performance but was unaware of any specific recent work on the GDP forecasts. He said that consumer confidence is still negative but is picking up from the lows of late 2022.

Pay growth has seen real wages rise….

Andrew Lilico said that pay growth had risen sufficiently to generate a small rise real wages showing some catch up. However, the most recent data showed a small fall back. On the issue of catch up, Trevor Williams pointed out that real wages were still below the peak level of 2008.

CPI inflation has fallen but still remains well above its target. The MPC has raised Bank rate continuously since December 2021 until it was held at 5.25% at its most recent meeting. This was the fastest rise in Bank rate since the rise in 1988 to 1989. Gilt yields have risen and have been consistently above the highs seen during the Truss volatility period. Sterling has depreciated a little since July 2023, but not dramatically.

UK Inflation and Monetary Conditions

M4ex growth has fallen sharply and is negative on recent data.

The Bank predicts inflation falling back to target by the second half of 2024 on the assumption of Bank rate remaining at 5.25%. This fits in with the market expectation of interest rates cuts in Q3. M4Ex growth has fallen sharply and is negative on the most recent data. Trevor Williams said that the trend in falling broad money growth reflects the unintended deflationary pressure of current quantitative policy. Roger Bootle asked if the trend in bank lending has the same pattern. Julian Jessop confirmed that it did..

Broad money stock gap is almost closed.

Andrew Lilico drew attention to a separate chart on the growth of M4ex, inflation, and the money stock gap. He said that at previous SMPC meeting there had been much discussion about the impact of stock versus flows of broad money, and the overhang of money holding following the lifting of the pandemic restrictions. Allowing for a 5% steady-state growth of M4ex as representative of equilibrium money demand. The difference between actual M4ex and the steady-state stock is taken as indicative of the broad money stock gap. The messsage that Andrew Lilico wanted to send from this chart is whatever the measure of the equilibrium value of money is, the sharp fall in the gap from nearly 10% in late 2022 to less than 2% in late 2023 suggests that the gap is now almost closed. The implication is that in the near term inflation could undershoot the target.

Inflation below target is not consistent with the fiscal gap

However, the deflationary force generated by the money supply numbers is inconsistent with the medium term fiscal situation that may not be adddressed without a higher inflation rate in the future. Andrew Lilico referred to charts of the 5-year moving average of public sector receipts as a % of GDP, public sector expenditure as % of GDP, and the deficit as % of GDP. The level of taxation has not consistently reached this level since the second world war. The question, he asked was whether the economy could sustain such high levels of taxation, either because tax revenue will not be generated or because growth weakens. Conversely cuts in public spending are promised but show no sign of occuring. He said plans of spending cuts are all promises for the future but that any material cuts will not happen because of political constraints. Greme Leach said that the issue links to the level of public debt and the productivity slowdown. Andrew Lilico said that if spending is 45% of GDP and tax revenue is 40%, and growth is 1%, inflation would need to be higher than 2%, on average over time, to make up the gap.

Thus, unless something changes to make spending fall, over the medium term there will be a need for a systemetically higher inflation target. Julian Jessop said that his view is that a 3% target would be beneficial.

Summarising, Andrew Lilico said that the Bank has overdone the tightness and his concern is they should now be worrying about deflation rather than inflation. He said that he wished that interest rates were lower but that his vote be for a hold subject to the rest of the committee persuuading him otherwise.

Discussion

Trevor Williams said that we should now move to a vote and thanked Andrew Lilico for his contribution.

Votes.

Votes are recorded in the order they were given.

Comment by John Greenwood

(International Monetary Monitor)
Vote: Cut Base Rate. End QT forthwith.
Bias: No bias.

Policy needs to get monetary growth right.

John Greenwood said that interest rates are the result of past money growth. The first effect of rapid money growth is that market rates go down. Then, as inflation fears take hold, the second effect is for interest rates to rise. That is what happened in Argentina and Venezuela, and this is where we are now. The optimum rate of broad money growth to meet the 2% inflation target needs to be 5-6%. However, the current sharp contraction in money growth indicates that the economy is going to turn down in 2024, and inflation may turn to deflation in 2025. This is a Monetarist interpretation. The Bank has the wrong notion that QT has no market impact. Negative monetary growth will happen for several months further. He said that interest rates are irrelevant and what needs to happen is to get monetary growth correct.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To cut Base Rate by 25bps. End QT.
Bias: to loosen and undertake QE.

End QT and undertake QE.

Patrick Minford said that money needs to be loosened. However, the interest rate is the instrument of policy and this need to come down. The gilt market reaction is resulting in an over-tightening of monetary policy. He said that we should end QT and to calm the gilts market there is a need for a return of QE.

Comment by Graeme Leach

(Macronomics)
Vote: To cut Base Rate by 25bps. No QT
Bias: bias to cut.

Fragile financial system - economy at a turning point.

Graeme Leach said that there is a good reason as to why the economy had not seen a recession yet. The rundown of forced savings built up over the lockdown has taken time. The lagged effects of rising mortgage rates have yet to take effect. John Greenwood also articulates the points on the Monetarist interpretation. Still, the Austrian school also would say there is a systemic build-up in the financial system and the accumulated malinvestments of the past 15 years that signal a turning point in the economy. The experience of the interest rate cycle in the US is that the rate always turns before a recession, and he said that he was afraid that this is what is happening in the UK. The markets may hail this as a good thing, but this may be the signal that it is about to happen here. He said that his initial inclination was to vote for a hold but is persuaded by the discussion and the evidence to vote for a cut.

Comment by Roger Bootle

(Capital Economics)
Vote: Hold Base Rate. Scaling back in QT
Bias: No bias.

Interest rates are fundamental.

Roger Bootle said that it was remarkable how many fundamentally different views about the variables that affect the economy can come to roughly the same conclusion. He said he cannot subscribe to the view that interest rates are irrelevant. He said that interest rates are fundamental whether operating on the short end or the long end. There is a debate to be had about the money supply, but it is not an instrumental variable. He said that he agreed that in the long run, there must be money growth stability, but policy does not operate on the money supply. He said that we cannot choose to focus on things that the Bank does not operate on. He said that he could see the beginnings of easing in the labour market and inflation easing. So, in contrast to previous positions of being a hawk on rates, he would like to see a hold.

Comment by Julian Jessop

(Independent Economist)
Vote: Immediate cut in Base Rate by 25 bps. End QT
Bias: No bias.

Small cut to affect expectations.

Julian Jessop said that there were three reasons as to why he wants to see an interest rate cut. First, money and credit conditions are too tight, and this means that inflation should fall more sharply than generally anticipated. Second, the fact that the Bank itself is forecasting that inflation will fall below target on the basis of unchanged rates suggests that it is right to cut them. Third, he said that at previous meetings he had argued for unchanged rates, and the MPC has consistently raised rates, therefore interest rates are already above where he thinks they should be. He said that the reason why he did not ask for a cut to the full extent of where rates should have been is because he believes expectations still matter and that too big a reversal would damage credibility.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To cut Bank Rate by 25bps. To hold QT.
Bias: No Bias.

Monetary policy is overtight.

Kent Matthews said that he was impressed by the chart that showed broad money growth negative for the OECD and the UK. He did not think that money stock could be destroyed once it is created and usually an excess of real balances does not adjust by the nominal money stock falling but through the price level rising. He said that he agreed with Julian Jessop that expectations play a part, and while monetary growth is fundamental to an interpretation of the economic situation, like Roger Bootle the rate of interest is the policy instrument. He said that at the previous meeting he had argued for a hold on the Bank rate as the economy was close to an equilibrium, but he recognises that monetary policy is dangerously overtightened, and a loosening is needed. Hence QT should be put on hold.

Comment by Andrew Lilico

(Europe Economics)
Vote: to Hold. Scale back QT
Bias: Strong bias to cut Bank rate

Trigger needed for rates to fall.

Andrew Lilico said that in the current circumstances there should be a scaling back of QT. He did not think that QT should be ended completely. He said it was a mistake to drive rates up above 4.5% but that it would be a mistake to cut from 5.25% back to 4.5% without the evidence of a trigger (e.g.a quarter of negative GDP growth). He said Bank rate should be on hold with a strong bias to cut.

Comment by Trevor Williams

(University of Derby and TW Consultancy)
Vote: Cut Bank rate by 25bps. Scale back QT to last year's level.
Bias: Cut as inflation falls

Wage growth does not drive price inflation.

Trevor Williams said he had been banging the drum about the contracting money supply and real wage growth being negative for some time, signalling underlying economic weakness and low long-term inflation pressure despite the supply-led inflation episode. Wages have been lagging prices for 15 years, so he was not worried about rising wages now. Trevor said wage growth does not drive price inflation in theory or practice and is no barrier to a rate cut. The logical conclusion of his analysis is that he should vote for a rate cut - despite market expectations - and that there should be a scaling back of QT but not an end. The bank must sometimes lead financial markets rather than be led by them on rate policy; therefore, it should cut interest rates now and explain to the financial markets that it's necessary to head off a significant undershoot of the inflation target in the next couple of years.

Comment by Peter Warburton (in absentia)

(Economic Perspectives Ltd)
Vote: To cut Bank rate by 25bps and phase out QT
Bias: To cut.

Peter Warburton commented: the collective disdain of the Bank's MPC for the money and credit data continues to present a source of danger for the UK economy. With M4x lending recording its seventh successive negative annual nominal growth rate in August and M4x growth tipping negative, there are emerging risks that liquidity and credit conditions have become too tight for the economy's health. In real terms, these growth rates are highly negative. During 2023, the increasingly cautious behaviour of lending and depository institutions has amplified the impact of the sequence of nominal interest rate increases. Corporate insolvencies are soaring, the unemployment rate has risen, and consumer confidence has taken another dive. While the output data is slightly better than expected, the outlook remains recessionary. No further tightening is appropriate, and a small rate cut would signify more clearly that the Bank is attentive to the unfolding squeeze on household finances. The persistence of inflation – which should ease materially in the coming months – should not be a distraction since it is the prospective inflation rate which matters for policy. While it will be very difficult to bring the public finances under better control in a stagflationary economy, it is now an urgent priority to do so. A mix of tighter fiscal policy (achieved through the reversal of post-Covid spending increases) and looser monetary policy is called for.

Any other business

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

Policy response

1. On a majority of seven to two the committee voted to cut Bank rate, with six wanting a cut of 25 bps at the November meeting.
2. Eight of the nine wanted to halt or reduce the pace of QT.
3. One member indicated that QE should be undertaken.

Date of next meeting

16 January 2024

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). 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).