Shadow Monetary Policy Committee

9th January 2024

Shadow Monetary Policy Committee votes to cut Bank Rate ¼% to 5%

At its first meeting of 2024, the Shadow Monetary Policy Committee (SMPC) voted unanimously for a cut in the Bank rate at the next Monetary Policy Committee (MPC) meeting. It also voted to cease quantitative tightening or QT because the money supply was contracting too quickly. It cited evidence based on monetary data in the US, the EU, and the UK that suggested they are at risk of economic growth stagnating later this year and inflation undershooting target if current policy stances are maintained.

There was discussion about the current trends in economic growth and price inflation, with the consensus that if the monetary policy stance is forward-looking, then the current level of interest rates in the UK are too high, and the risk of a sharp slowdown or recession would mean inflation would undershoot its target. Moreover, members pointed to the current inflation rate being well below what was expected by the monetary authorities a few months ago, with one member suggesting that consumer price inflation could fall to 2% as soon as the second quarter of this year.

Although eight out of nine members voted for a cut in interest rates of 0.25% of a per cent, one member suggested that rates should be cut immediately by half a per cent on the basis that the MPC should be looking at inflation two years ahead and with the current stance of interest rates there will be an undershoot and possibly deflation. Therefore, action to loosen monetary was warranted immediately.

The vote to cease QT was that the fall in the stock of money (as occurring now) would undermine what prospect for economic growth there was. It was unnecessary since price inflation was already on track to meet or undershoot its target a year earlier than forecasted, as recently as November 2023. Two members argued that the priority is to get money growth up to about 4-5% per annum from its current decline of around 2-3%, which would require QE and lower interest rates.

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 9 January 2024 Institute of Economic Affairs (hybrid meeting)

Attendance: Juan Castaneda (online), John Greenwood (online), Julian Jessop, Andrew Lilico (online), Kent Matthews (Secretary – online), Trevor Williams (Chair), Peter Warburton (online).

Apologies: Graeme Leach, Tim Congdon, Patrick Minford

Chairman's comments: Trevor Williams welcomed members to the first meeting of 2024. He said that the world is seeing momentous events. Over four billion people are voting in 2024. Wars in the Middle East and in continental Europe make for interesting geopolitical times in the year ahead. But with falling inflation, interest rates are set to be cut virtually everywhere. He invited Julian Jessop to provide his analysis of the global and UK domestic economic environment.

Global backdrop

An uneven recovery

Julian Jessop said that the PMI data showed that global activity picked up at the end of 2023 helped by falling inflation and expectations of lower interest rates. The latter was a game-changer for some economies. However, it is an uneven recovery across sectors, with manufacturing remaining weak and services doing better. Another unevenness is in the performance of countries. Unusually the UK had the highest PMI reading – covering services and manufacturing - of any G7 economy. Trevor Williams questioned the performance of UK manufacturing given the global chokepoints in trade. Julian Jessop said that UK manufacturing has done well since 2016, and on most recent data has done less badly than the rest of Europe.

Broad money growth negative….

Julian Jessop said that he planned to say more about the UK monetary data later but pointed to the sharp monetary deceleration in the USA and Eurozone. The rate of growth of broad money in the last 12 months in the USA was -0.4% and in the Eurozone -1.0%. He said 2024 could be the year the USA underperforms.

…Bank set to meet inflation target 18 months earlier than expected.

He said that UK inflation tends to follow the downward path of the US and hit 3.9% in November. The November Monetary Policy Report included the Bank of England expectation for inflation to average 4.6% in Q4 2023, and 4.4% in Q1 2024. Inflation is not expected to return to 2% until Q4 2025. Julian Jessop said that inflation is on track to hit the 2% target in Q2 2024, a year and a half earlier than forecasted.

Food price inflation keeps on falling with the prices of some staples falling outright. But core inflation remains sticky. Core inflation in the UK was 5.1% in November, well below its peak of 7.1% in May. Core goods price inflation is expected to collapse, leaving services sector inflation as the main worry for the Bank. Trevor Williams questioned if the timing and impact of energy costs on goods and services inflation mean that some of these impacts have not been recorded yet. The pass through to headline inflation is also different between manufacturing sector and services, slower in the latter than in the former.

UK Economy

UK contracted less than Eurozone.

Turning to the UK growth data, Julian Jessop said that the UK has dodged technical recession so far, although GDP per head has already fallen for two successive quarters as in mid-2022. While overall GDP might also have contracted in Q4, the composite PMIs indicate that the UK had contracted less than the Eurozone and is showing signs of life earlier.

Brighter consumer confidence.

He said that consumer confidence ended 2023 on a brighter note. People are much less pessimistic about their personal finances. He said that this mainly reflected falling inflation and stronger job security but cuts to National Insurance Contributions, and the rise in the national living wage and state benefits must have also helped. Along with consumer confidence, business confidence has also improved as shown by the Deloitte CFO survey. CFOs are more optimistic about 2024 although hiring is likely to remain weak. Expectations of wage growth have moderated from 6.1% in the past 12 months to 3.4% in the following 12 months.

Julian Jessop referred to the remainder of his presentation slides. Wage surveys are indicating pay rises of 4-5% as the norm for the private sector in 2024, which in his view represents a catch up and does not represent a new threat. On other supply factors, he said that tensions in the Middle East have had little impact on oil prices, and other supply chain shocks pose relatively little threat.

In conclusion Julian Jessop stressed that the purpose of monetary policy is to hit an inflation target of 2%. On current trends, the Bank is likely to hit this target 18 months earlier than it expects.

Discussion

Andrew Lilico posed the question that since there is a significant monetary contraction happening in the UK, and this is happening after a prolonged period of zero interest rates and QE, is there a technical reason why we should be less worried about negative monetary growth today than say 20 years ago? He asked if there is any reason – for example if the process of quantitative tightening has changed - that we would interpret the falling monetary aggregate measure differently today?. Julian Jessop said that this goes back to what was discussed at the previous SMPC meeting: the recent weakness in the growth of the money supply has brought the stock back in line with its long-term trend relative to national incomes. This could be interpreted in different ways, but his take is that this is consistent with a further sharp fall in inflation.

Kent Matthews said that he was at the American Economic Association annual conference in San Antonio attending a session on inflation and monetary policy. When he asked as to the significance of the money supply figures in indicating monetary policy stance, the representative from the Reserve Bank of Dallas said that there was an index of monetary conditions made up of over one hundred items of which the money supply was just one! The index suggested that inflation had not yet been squeezed out of the system in the USA and interest rates would have to remain high for longer. Juan Castaneda said that this means that the monetary overhang in the USA is still there but the key difference with the UK is that the monetary overhang in the UK has been eliminated.

John Greenwood said that looking at the stock alone is insufficient. He said that it was wrong to think that because the stock is high, it can be reduced without side effects. It is the current, sustained rate of change that was important. Having seen the excess money work through the system in the past 3-4 years (impacting asset prices, then economic activity and finally inflation), there is now a contraction of money growth that is driving inflation down. In the USA he said that his calculations suggest that the monetary excess has virtually disappeared. So, the effects of the decline in the quantity of money will be seen in the next six months.

Andrew Lilico said that the arguments he has heard elsewhere are that the relationship between money growth and inflation is different when coming off a period of low interest rates and QE for technical reasons and that a specific growth

of money does not presage a specific rate of inflation as in the past, particularly when undertaking QT. He said that presumably this is not a view that finds favour here. Juan Castenada agreed.

John Greenwood said he also agreed and said that this is a view that comes from the Bank of England. The Bank views QE and QT as having asymmetric effects. The Bank sees QE as positive in a crisis, but QT can be done without any effect on the economy. Andrew Lilico asked whether we should be more concerned with the size of the negative money growth numbers compared with a zero growth. John Greenwood said that we should be concerned. In the USA it is the third most severe downturn in money growth since the founding of the Federal Reserve. Historically each of these downturns has been followed with a prolonged recession and deflation. In the UK there has been no precedent for this kind of downturn in money growth.

Andrew Lilico said that the Bank inflation forecasts have consistently undershot the reality since it has started to fall and the downturn in inflation will likely continue with the Bank continuing to undershoot. He said that he was surprised that there was no market pressure on the Bank to ease interest rates earlier. John Greenwood said that the Bank had underestimated the inflation from the monetary growth and is continuing to sleepwalk over the effects of the monetary contraction and the market is buying their narrative that the rate of growth of money has no implication for inflation.

Andrew Lilico said that he was astonished to listen to the Governor of the Bank being questioned by Lord King as to what his theory of the rate of inflation is, to hear him say that he had no theory. Kent Matthews said that the Governor is in good company as there were many distinguished monetary economists, he heard at the AEA conference saying much the same thing, that inflation is caused by several factors and not monetary growth alone. Andrew Lilico said that it seems that the consensus here is that these negative money growth figures are a cause for concern, and that this means that we should be having sharp interest cuts immediately.

Juan Casteneda said that he would like to see a stop to QT first followed by cuts in the base rate. This is to assess first the effect of stopping QT on money growth. John Greenwood agreed with this.

Votes.

Votes are recorded in the order they were given.

Comment by Andrew Lilico

(Europe Economics)
Vote: to cut by 25bps. Suspend QT
Bias: Strong bias to cut further

Immediate cut by 25bps.

Andrew Lilico said that the Bank has pushed interest rates too high, and they have been undershooting with their inflation forecasts. They should be backing out of their position or else they will see a very large undershoot of their inflation target. They should act now with an immediate cut by 25 bps and a suspension of QT. With a bias to cut further by a further 25 bps.

Comment by John Greenwood

(International Monetary Monitor)
Vote: Cut Bank Rate by 25bps. End QT forthwith.
Bias: No bias.

Planned QT will reduce the stock of money by £100bn.

John Greenwood said that the first thing is stop Quantitative Tightening (QT). Up until September 2023 the MPC voted to reduce bond purchases by £80bn per annum. At the September 2023 meeting they voted to reduce bond purchases by £100bn between October 2023 and September 2024. Other things equal this means no growth in bank lending and a reduction in the money stock by the same amount. The Bank is wrong to think that it is a stock that can be run down without consequences. Doing QT reduces the stock of money to the public. We are a going from a period of excess money growth to a period of inadequate money growth. The priority is to get money growth to about 4-5% per annum.

Comment by Juan Castaneda

(Vinson Centre, University of Buckingham)
Vote: Cut Bank Rate by 25bps. Halt QT.
Bias: No bias.

Priority is to stabilise money growth at 4-5%.

Juan Castaneda said that he shared the thinking of John Greenwood, and his vote will be very similar. The priority for the Bank is to stabilise the rate of growth of (broad) money in the 4-5% range per year. He said that the current levels of money destruction are deeply worrying. He said that he did not think it would make a big difference, but Base rate should be cut by 25 bps as a signal to the market. There should be a stop on QT.

Comment by Julian Jessop

(Independent Economist)
Vote: Immediate cut in Bank Rate by 25 bps. End QT.
Bias: To ease further.

No justification for keeping Base rate this high.

Julian Jessop said that his vote was the same as the previous meeting, which is to end QT and to cut the Bank rate by 25 bps. He said that the Bank of England's job is to get inflation to 2% and to keep it there. This will happen in the second quarter of 2024. So, there is no justification for keeping interest rates as high as they are now.

Comment by Peter Warburton

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

Peter Warburton said that he was not impressed by the consistent downward trend in inflation towards 2%. He said that 2% may be the immediate destination but it will not be the lasting one. The reason for this is because the public sector finances are out of control and that we are losing momentum in the private sector. The economy has been heavily dependent on public sector expenditure in the last

2% is the immediate destination for inflation but not the lasting one

two to three years. Private expenditure per capita is well down from the 2019 level. There is no question that we are in a private sector recession. The choice is to keep pumping the public sector to prop up the economy or to let nature take its course. The latter being the only way to get the economy back in balance and keep inflation at the target for the long term, subject to sensible monetary decisions being made. We are currently running at a 5.3% of GDP public sector deficit excluding the banks. There are no plans in the immediate future to get the public sector deficit to below 3 per cent of GDP. He said that QT must not only be ended, but QE should be brought back. That will get the money supply figures bounding back but risk sending us on another loop. We are in a dangerous situation now, but the Bank like the Federal Reserve will be forced out of its restrictive stance. The UK is in a precarious position, and we need to start cutting interest rates, end QT and prepare to undertake QE to stabilise the market. He said that he is not confident that inflation will remain at 2% when it gets there.

Comment by Trevor Williams

(University of Derby and TW Consultancy)
Vote: Cut Bank rate by 50bps. Scale back QT if rates are not cut immediately.
Bias: To cut

Cut Base rate by 50 bps now.

Trevor Williams said that the Bank of England should cut the Bank rate by 50 bps immediately, a further 50 bps cut in the April MPC meeting, and a further cut of 25 bps in May to take the Bank rate to 4%. Rates should be gradually cut in the second half of the year in quarterly increments to take them to 3% at the December meeting. Such a rate would be entirely justified by sub-2% price inflation before the end of the year and economic growth under 1% or an economy skirting recession. He said that he was also persuaded that QT should be ended until rates are cut but thinks that the debt mountain has distorted investment decisions and should continue to be scaled back in the event of the rapid pace of rate cuts he has suggested.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To cut Bank Rate by 25bps. To end QT.
Bias: To cut.

Kent Matthews said that at previous meetings Philip Booth would go on about how flexible the UK labour market is. Given the dire state of the money supply figures one would expect this to be reflected in a sharper slowing down of the economy. The fact that this is not happening and indeed Julian's figure show that consumer confidence has picked up, means that inflation expectations have receded. Which means that the market is expecting the bank of England to reverse the monetary overtightening no matter what its rhetoric is about what they are doing currently. What we know about rational expectations is that an expected monetary impulse has less of a real effect than an unexpected one. He said that maybe this what is going on here. We may see inflation come down rapidly with less of a real contraction than we think because of the expectations effect. He said that he presented a paper a few years ago to the IIMR conference and Tim Congdon asked him to address the empirical question: is inflation is determined by inflation expectations, or money supply growth? It turns out that both influence inflation but that inflation expectations are influenced by money supply growth as well. He said that he also understood Peter Warburton's point about the fiscal-monetary imbalance. If the current deficit is expected to be maintained into the future for a long period, the market would have built this into long term inflation expectations and be reflected in long term rates. But this is not happening. It follows that the market expects fiscal policy to come under control and the current monetary

stance to ease because policy is not consistent with market expectations. He said that his vote is reflecting market expectations and would like to see an immediate cut in the Base rate by 25bps with a bias to cut further and to end QT. Of course, the market could be wrong. If the Bank continued with its current policy and did not reverse the negative growth in money supply and lower interest rates, we would all be in for a nasty shock!

Inflation expectations are influenced by money supply growth.

Comment by Patrick Minford (in absentia)

(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 his positioned has not changed since the previous meeting. He said that money needs to be loosened but since the Bank rate is the instrument of policy, this needs 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 Philip Booth (in absentia)

(St Marys University)
Vote: To cut Bank Rate by 25bps. Suspend QT.
Bias: No bias.

Philip Booth voted to cut by 25bps and suspend QT.

Any other business

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

Policy response

1. There was unanimous agreement that monetary policy needed to be loosened and eight members of the committee voted to cut Bank rate by 25 bps.
2. One member voted for an immediate cut to Bank rate of 50 bps.
3. There was unanimous agreement to halt QT.
4. Two members said that monetary growth had to be stabilised in the 4-5% range.
5. Two members said that the Bank must prepare for QE.

Date of next meeting

9 April 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).