## Minutes of the meeting of 9 July 2024 Institute of Economic Affairs (hybrid meeting)

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

**Apologies:** Tim Congdon, Jamie Dannhauser

**Chairman’s comments**: Andrew Lilico welcomed members online and said that Trevor Williams, Philip Booth, and Julian Jessop will be joining as we go on. He invited Graeme Leach to present his assessment of the economic and monetary situation.

**US economy and monetary growth deceleration**

Graeme Leach began by referring to the presentation he made about this time in 2023 where he had highlighted the unrealised losses in the US banking system and the sharp deceleration in monetary growth. He said that at that time he was extremely bearish about the outcome for the US economy, but US growth has performed much better than expected. He said this was in part due to the monetary overhang from previous years together with the scale of the budget deficit. However, he remains of the belief that the sharp slowdown in broad money and problems in the banking system will still impact the US economy hard. The three-month annualised growth in M3 was down to 1.3% in April and in the year to April was 2.3%. He said that this is a phenomenal deceleration in M3 growth compared with the average in the ten years to 2020.

US economy holding up confounding bearish prediction.

He said, contrast this with China where money growth is around 6% but much lower than what it has been in recent years. Combined with the beginning of deflation in the housing market and consumer prices, up 0.3 per cent year on year in April, there is a significant deflationary force building up. Further East in Japan money growth is at a 16 year low. Inflation in May was 2.8% up from 2.5%. In Q1 GDP declined by 0.5% so nothing particularly robust going on.

Deflationary force building up in China.

In the eurozone there is also a sharp slowdown in monetary growth. The year to year growth in April was 1.3% and in the three months to April annualised it was 2.8%. The effect of this monetary slowdown is translating into a sharp deceleration in inflation.

**UK Monetary Conditions**

Focusing on the UK alone, the latest panel of independent forecasts from the Treasury suggests that growth is expected to be around 0.6% for the year and 1.2% next year. CPI inflation is expected to slow to 2.1% this year and 2.2% next year. There is quite a divergence in growth expectations with the lowest at -0.2% and the highest at 1%. Similar disparities exist for next year, with growth ranging from 0.7% to 2% and inflation in the range of 1.1% to 3.4%. Looking at the latest ONS data we see that GDP growth in 2023 was just 0.1% but in Q1 of 2024 growth was 0.7% which is not looking too bad for the year. He said that whether that performance is sustained is to be seen and if his fears on the US front are realised the UK outlook will turn for the worse. Taking a longer-term perspective, he said that he was pessimistic about a new government being able to change the underlying growth situation.

Divergence in growth and inflation forecasts.

Monetary growth in the UK has also decelerated sharply in recent years but over the latest three month period there was an improvement. Year on year M4 growth was down in April to 0.4% but in the three months to April there was an acceleration with an annualised rate of 4.5%. Headline inflation is down to 2% in May from 2.3% in April. Core inflation was obviously higher at 3.5% but that also was a decline from 3.9% in April.

The Bank of England view is that whatever relationship there is between money growth and inflation in the long term, there isn’t one in the short term. Hence according to the Bank of England, M4 cannot be used for forecasting or projections. Graeme Leach said that he disagreed with this conclusion and asserted that over a 18-24 month lag the relationship is much stronger. He said that what the Monetary Policy Report shows is nominal GDP running well ahead of M4 which suggests that the slowdown in nominal GDP has got further to run. As in the US, he said the weakening in nominal GDP growth has not fully materialised yet due to the monetary overhang from the pandemic.

Bank view is there is no short-term relation between money and inflation.

Graeme Leach said that he still had a bearish view of the economy and felt that 2024Q1 quarterly growth of 0.7% was not sustainable. He showed that a 0.1% increase in the CPI month on month for the remainder of this year would generate an inflation rate broadly on target in the second half. Anything higher than this monthly growth rate would likely hinder the prospects for interest rate reduction.

In terms of the non-monetary areas of the economy, Graeme Leach said that there has been a loosening of the labour market in the past 12 months with the fall in the vacancies to unemployment ratio. Bank of England projections for wage growth based on a whole swathe of models, show wage growth falling from the present 5% to below 4% by the end of the year, and below 3% in the next year. However he doubted whether the MPC would be as relaxed as it should be about the wage inflation threat.

Loosening of the labour market … wage growth projected to fall.

Also on the plus side, the GFK personal financial confidence measure is improving. Graeme Leach said that the reason why he focussed on this measure is because the wider overall economic confidence measure tends to be more negative and the personal consumer confidence measure is a better indicator. Household real incomes and saving projections by the Bank of England are solid. A 3% projection in real disposable income is not a harbinger of slowdown. So, there are some conflicting signals from monetary growth and the real economy, with the latter stronger than the former, with the lagged effects of the monetary slowdown yet to fully work through. What is clear is that inflation is yesterday’s story.

With house prices, the expectation from Halifax was a fall in house prices of 4-5% at the beginning of the year, but house price inflation is running at 2% currently. He said that clearly this not a boom time but it is not a bust either, or certainly not the contraction that was expected. Mortgage data from the Bank of England published by the FCA show the weighted average of fixed rate mortgages not rising but easing this year.

House prices not fallen as expected.

Graeme Leach said that to finish off his presentation he wanted to look at the impact of the Labour government and how that might change the near-term projections. The consensus is that it does not. There is not a lot of headroom in terms of fiscal adjustment. He said that since 2010 the headroom against fiscal rules has averaged £26 billion but now it is down to just £9 billion. Given the election promises not to raise a swathe of taxes, the new Chancellor is somewhat boxed in. Moreover the Labour government is not going to keep the welfare spending cap set by the HM Treasury which was £137 billion for 2024-5. So, if they take the welfare spending cap off, this means that they are going to have to raise even more taxation elsewhere. What this means is that the existing post-war high of the tax to GDP ratio in 1948-50 is going to be exceeded.

No fiscal head room.

Graeme Leach said that politically the spending pressure on the Labour government is considerable. Post Covid health related benefit payments have exploded and this will add to the tax and spend pressures. These have gone up in 2024-25 prices from £35 billion in 2018-19 to £48.3 billion in 2023-24 and are projected to rise to £63.7 billion in 2028-29. This represents a £28.2 billion increase in a decade. With these pressures Graeme Leach said that he cannot see how Labour can avoid raising tax.

Spending pressures and tax rises.

The question is whether GDP growth can be raised to provide a countervailing force? He said that he could not see how growth could be raised by continuing to raise public sector output. Statism is undermining not promoting GDP growth.

Can growth be increased?

He said that Labour is keen on so-called modern supply-side economics which involves, R&D, infrastructure, and human capital formation. But people have been tinkering with this for decades and it has not affected the long-term underlying potential output growth. Indeed, long-term potential growth has declined in the past 20 years.

Graeme Leach concluded that he is growth pessimistic, and he is tax pessimistic. In the near term, the real economy indicators suggest reasonable growth performance this year. But the legacy of the monetary slowdown is yet to fully be felt.

**Discussion**

Andrew Lilico said that to start the discussion off he said that in his view there are four factors to consider of which Graeme has covered three. There are two negative factors and two positive factors. The first negative factor is the lag in effect of monetary policy which is long and variable and could have effects that take sometimes as little as 18 months and sometimes up to three years. The second negative is a fiscal crisis. We have high levels of debt and there may be increased taxes to reduce an unsustainable deficit. On the positive side there could be some structural underlying acceleration in growth from new technologies.The fourth factor is that in the context of international turmoil (e.g. with Biden’s problems in the US, France’s problems in the eurozone), Labour’s huge victory may provide the UK with a safe haven effect, with associated capital inflows for the next year or so. The story is that we don’t have to run as fast at the chasing bear, just run faster than the others (in this case other countries with fiscal problems). We may be bad but elsewhere is even worse. The result is that there might be a monetary boost, an output boost, or a combination of both.

Safe-haven effect in UK and capital inflows.

Philip Booth said that such an effect could reduce equilibrium interest rates and there is also the potential of a Dutch disease effect from the exchange rate.

Graeme Leach said that the examples of the superstar firms like Facebook, Amazon, Netflix, Google have exceptionally high productivity but the AI effect that Andrew Lilico mentioned is long expected but has not happened. On the capital flows argument he said that given the French left promises may increase the French debt-GDP ratio by 10 points, he couldn’t see how that feeds into the UK. He said that one could argue that Labour is different from the French Socialists or you could argue that capital is wary of all left-wing governments and we don’t get that positive effect.

Capital wary of left-wing governments.

Patrick Minford added that Labour has got the wrong policy for growth and that he was growth pessimistic too. He said that he had seen that state led policies do not produce growth.

Graeme Leach said that monetary growth is weak and there is no inflationary threat and that there should be at least a 50 bps cut in Bank rate.

John Greenwood said that his observations are like Patrick Minford’s that the Labour team is headed for state led growth, but the Bank of England is on a contractionary monetary course. And we are still feeling the effects of the prior slowdown that is pointing to a slowdown in nominal GDP. He said that inflation will fall below target in 2025 and in 2026. In the meantime, GDP growth will be anaemic. The general environment is going to be like the immediate post GFC period, that people will have the feeling that austerity policies are in place, and capital taxes will be increased. Far from a positive FDI effect, he said there is a greater likelihood of the reverse – a capital flight from the wealthy. He said that the Bank of England should end QT and cut rates immediately. The Bank is overly worried about service price inflation and wage inflation.

Capital flight from the wealthy.

Philip Booth said that real wages are a lagging indicator and since they have dropped, wage inflation is a catch up.

Julian Jessop said that from a naïve perspective, we have had zero growth and 2% inflation, which is not inconsistent with the rapid decline in broad money growth that we have seen. More recently, money growth on the 3-month annualised figure has accelerated which is consistent with the pickup in economic growth.

Zero growth and 2% inflation are not inconsistent with the rapid fall in money growth.

Patrick Minford said that the main point is that we have had this big slowdown in money growth, and this has had a huge effect on inflation. We do not have particularly good forecasting models to say that what is happening is out of line with what we expect from this. Another point is that commodity prices have dropped because of the worldwide tightening of money. None of this is inconsistent with the basic theory.

Andrew Lilico asked about the US given that some have been saying that they were expecting a recession to occur there. Patrick Minford said that the US has had an enormous fiscal policy expansion that is quite out of line with the monetary tightening. He said that fiscal policy is much more important than what people give it credit for.

Fiscal policy has one time effect, whereas monetary money increases have a prolonged effect.

John Greenwood said that fiscal spending is a one-time effect whereas an increase in money has a prolonged effect. There has been a significant slowdown in monetary growth but the effects of the overhang of surplus money is still working its way through. For the UK, he said that we are looking at below target inflation in 2025 and possibly some months of deflation in 2026.

Andrew Lilico said that the discussion underscores what he said earlier about the lag in effect which could be 18 months, or it could be 3 years. He said that if we are confident about this perhaps, we need to be more aggressive with interest rate cuts.

John Greenwood said that he had done some work matching the peaks of inflation and the peaks of money growth for 20 countries and for the US, UK, Eurozone, and Canada, the lag in effect varied from 17 months to 23 months. This is exactly what you would expect. He said that it is possible that the lag may be longer in the downswing.

Lag in effect is 17-23 months but could be longer in the downswing.

Patrick Minford said that it is worth mentioning that the monetary policy operating system has changed enormously. The huge contraction in money growth has been accompanied with a £40 billion windfall to the banks through the reserves policy. John Greenwood said that this £40 billion simply replaces the profits on the lending the commercial banks would otherwise have undertaken.

Interest earning on reserves replaces bank lending.

Andrew Lilico said that before the meeting winds up and we move to a vote, he asked if the committee had any ideas on changes to the mandate of the Bank they would wish to propose.

Julian Jessop said that from an intellectual perspective he was in favour of a nominal GDP target, but the 2% target has been around for a long time, and we have only recently hit it. There is a pragmatic case for keeping it as it is. The only other variance is to raise the target to say 3%.

Andrew Lilico said that the Blanchard argument for having a higher target rate of inflation is that it allows interest rates to fall in times of crisis without hitting the zero lower bound. But in fact following the GFC, we did hit the zero bound.

Andrew Lilico asked the meeting to move to a vote.

**Votes**

Votes are recorded in the order they were given.

**Comment by John Greenwood**

**(International Monetary Monitor)**

**Vote: Cut Bank Rate by 50bps. Stop QT.**

**Bias: No bias.**

John Greenwood said he votes firstly for the ending of QT because reducing the Bank of England’s balance sheet is equivalent to slowing the growth or reducing the quantity of money. And second, he votes for a cut in Bank rate to secure a broad money (M4ex) growth in the order of 4-5%. If the response is a rapid increase in bank lending which translates to a rapid increase in broad money, that would be a signal not to continue. But that would not be the case now. He said that he votes for a 50bps cut.

Reducing the Bank’s balance sheet is equivalent to slowing growth of money.

**Comment by Patrick Minford**

**(Cardiff Business School, Cardiff University)**

**Vote: To cut Bank Rate by 50bps. Hold QT.**

**Bias: No bias.**

Patrick Minford said that he did not agree with John Greenwood on the effect of fiscal policy, but he agreed with everything else he said, and his vote is for a cut in Bank rate by 50bps and a suspension of QT

C**omment by Graeme Leach**

**(Macronomics)**

**Vote: To cut Bank Rate by 50bps. End QT**

**Bias: No bias.**

Graeme Leach said that he was cautious because of the acceleration in broad money growth to 4.5% in the latest three months, as this was edging towards the upper boundary of the safe range specified by John Greenwood. He said that there was more slowdown to come through and that the effect of the monetary overhang is not complete. He voted for a 50bps cut in Bank rate.

Cautious about the acceleration in broad money in latest 3 months.

**Comment by Philip Booth**

**(St Marys University)**

**Vote: To cut Bank Rate by 100bps.**

**Bias: No bias.**

Philip Booth said that we have had a long period of several years, even ignoring the time when inflation surged, where real short-term interest rates have been around negative one percent. Current indexed link yields are saying that implied real interest rates are in between ½% to 1%. Real short-term interest rates today are about 3%. And the policy rate is well above what nominal gilt yields indicate is the expected long-term average of interest rates, despite inflation being at target. It is hard to see what justification there is for rates being tighter than their expected long-term norm. So, from that perspective there should be a significant cut in interest rates. He voted for a cut of 100bps.

Real interest rates are 3% for a target inflation.

**Comment by Julian Jessop**

**(Independent Economist)**

**Vote: Cut in Base Rate by 50 bps.**

**Bias: No bias.**

Julian Jessop said that he wants to make a couple of points. The first point is that the Bank of England is paying far too much attention to wage growth first because it is a lagging indicator and second, it is a relative price among many other relative prices. There are reasons to welcome an increase in real wages when there is a labour shortage problem in the economy. The second point is the issue raised by Patrick Minford on the payment of interest on reserves. There is an overlap with this and fiscal policy. One disadvantage of ending QT is that the government will be spending more money than what it otherwise would because the commercial banks would be holding more reserves. So, there may be an argument for continuing with QT and review the payment of interest on reserves to free up a bit more money for productive use. Interest rates are more restrictive than they need to be and so he votes for 50bps cut in Bank rate. He would also end QT in combination with a review on interest payment on reserves.

Ending QT means banks holding more reserves and higher interest payment on reserves

**Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: to cut Bank rate by 50bps. To end QT**

**Bias: Strong bias to cut further**

Andrew Lilico said that his position would combine a couple of points. He said that Philip Booth put it quite nicely that given the current inflation rate and plausible expectations of where it will go, and it is likely to go down further, the gap between the interest rate implied by gilt yields and the policy rate is much greater than it need be. He asked why should policy rates be so much higher than the market real long-term interest rates? What problem is being addressed by this? He said that there may be some combination of a jump in the medium-term growth rate or some policy calming risk premium. He said that he was inclined to the notion that there will be a safe-haven effect. He said that his vote is to end QT and a cut in Bank rate of 50bps with a strong bias to cut further.

Why real short-term interest be so much higher than real long-term interest rates?

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**Comment by Kent Matthews**

**(Cardiff Business School, Cardiff University)**

**Vote: To cut Bank Rate by 50bps. To end QT.**

**Bias: No bias.**

Kent Matthews said that he expected to see a greater loosening of the labour market given the expectations raised about the sharpness of the fall in broad money growth. This has made him a little cautious about being bold with interest rate cuts, but he felt that 50bps cut was about right. He reported on some work he had done with a colleague using a VAR system of broad money, GDP growth, inflation, and measures of inflation expectations from survey to market implied. He found that the lag in effect for the UK was about 18 months, so he was expecting to see a bit more evidence of a loosening in the labour market and slowdown in the economy, However, as John Greenwood said it may be that the lag is longer in the downswing and the effect of the monetary overhang has not fully worked through. As this created some uncertainty, he said that he would wait and see the effect of a Bank rate cut and he had no bias.

The lag in effect of monetary policy is about 18 months.

C**omment by Trevor Williams**

**(University of Derby, TW Consultancy, and FXGuard)**

**Vote: Cut Bank rate by 100bps**

**Bias: To cut further, continue QT**

I agree with Graham's assessment that UK economic growth will be about 1% this year, which aligns with the UK's growth potential based on a production function approach. Taking into account the decline in commodity prices and the weak growth rate of broad money supply M4, UK consumer price inflation is consistent with a 2% increase or below for the next few years. Moreover, as Phillip Booth points out, the gap between the current indexed link yields that imply 'real' interest rates are between ½% to 1% rather than the 3% rate we observe is large. Such a difference justifies significant cuts in the nominal Bank rate of 5.25%. I vote for an immediate reduction of 1%, with a bias to further significant easing over the coming months. QE was required when monetary policy hit the zero bound, now that is no longer the case it should be reversed.

Cut Base rate by 100 bps now.

**Comment by Peter Warburton (in absentia)**

**(Economic Perspectives Ltd)**

**Vote: To cut Bank rate by 25bps and end QT**

**Bias: To cut to a target rate of 4%.**

Despite the previous government’s best efforts to shield the UK economy from the taint of recession, the latest national accounts confirm that GDP per head is 1.3% smaller than 2 years ago, notwithstanding a small increase in the first 3 months of the year. Aided by a 20.6% increase in social security benefits, gross household disposable income rose by 16.5% over this period. However, the impact of inflation reduced this to a real disposable income increase of 3.7% over the two years. An offsetting rise in the saving rate, from 4.6% to 8.4%, has robbed household consumption of all momentum. Overall spending has been flat for the past two years, but the recovery of tourist spending (on a net basis) flatters the figures.

Domestic consumer spending is 0.7% lower than 2 years ago. We can consider expenditures on housing, health and education as mandatory for the most part, leaving a sub-total of discretionary spending 1.3% lower. Consumer spending on goods has taken the brunt of the adjustment: a 6.3% drop in durable goods, a 5.7% decline for semi-durable goods and a 4.7% hit for non-durables. Recreation and culture spending fell by 2.8% within the more robust services categories. Retail sales volumes in the first half of the year were 2% below the volumes in the first half of 2019. A survey from KPMG found that “four in ten British households are saving about £77 per month by reducing expenditure on discretionary items after two years of a cost-of-living squeeze”.

The average mortgage bill is around £2,000 a year higher than at the start of 2022, and the pain of interest rate resets has further to run. It took a suspiciously favourable movement in the UK external account (of more than £5bn, quarter-on-quarter), to deliver the reported 0.7 per cent quarterly gain in Q1. While forecasters have grown more confident of a shallow upturn in the UK economy, consumer behaviour points to a more cautious outlook, one which may already reflect a widely expected increase in the tax burden under the new government.

In real terms, the M4 money stock and M4 lending stock are still declining, with the mortgage stock static in nominal terms for more than a year. Ten-year gilt yields remain almost as high as in October 2022, as overseas investors increasingly perceive gilts as a losing proposition while QT is in force. It is high time to cease QT. There is also a strong case for cutting Bank Rate immediately, with the intention to cut further during the rest of the year.

**Any other business**

Philip Booth said that there was a time when the Governor of the Bank of England hosted meetings with the SMPC to elicit the views of its members. This occurred under the watch Governor Mervyn King. Given the bank's desire to widen its exposure to a diverse range of voices, he suggested that the Chairman write to the Governor and mention our past engagement and that we would be happy to meet them again. Andrew Lilico agreed to action.

**Policy response**

1. There was a majority agreement that monetary policy needed to be loosened.
2. A majority of the committee (six) voted to cut Bank rate by 50bps immediately.
3. Two members voted for an immediate cut of Bank rate by 100bps.
4. One member voted for an immediate 25bps cuts and a bias to keep cutting to reach a target Bank rate of 4%.
5. There was a majority agreement to halt QT.
6. One member voted to continue with QT.

**Date of next meeting**

8 October 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).