

Minutes of the meeting of 16 April 2024 Institute of Economic Affairs (hybrid meeting)

Attendance: Roger Bootle, Philip Booth (online), John Greenwood (online), Andrew Lilico (Chair), Kent Matthews (Secretary – online), Trevor Williams, Patrick Minford, Peter Warburton (online).

Apologies: Juan Castaneda, Tim Congdon, Julian Jessop,

Chairman's comments: Trevor Williams thanked members for their engagement in the last year and formally handed over the chairmanship to Andrew Lilico. Andrew Lilico welcomed members to the second meeting of 2024. He invited Trevor Williams to present his assessment of the economic and monetary situation and referred to the first item on the agenda which is the Bernanke Review.

Bernanke Review

Trevor Williams said that the Bernanke Review highlighted the deficiencies that have contributed to the Bank's poor performance, and addressing them is deemed crucial for improvement in its performance. The key takeaways are:

1. The lack of investment in forecasting infrastructure.
2. The exclusion of monetary and financial indicators.
3. Outdated and inadequate models.
4. Poor communication practices.
5. Reactive rather than proactive guidance.
6. Inadequate recognition of structural changes.

Andrew Lilico said that his interpretation of the issues relating to the fan chart is that although it was an early invention, it is now obsolete. He said that the Bank's model was anchored at the long-run target of 2%, and mixing it with the fan chart meant that whatever policy the Bank did, inflation always tended to fall back to 2%. Whether the Bank did nothing in response to shocks or even something perverse, inflation always returned to 2%. Regarding structural changes, the role of diversity should be about diversity in intellectual position on monetary theory rather than diversity in gender or background, which the Bank seems to have been stuck on.

Global Monetary Backdrop

Trevor Williams said that the 12-month broad money growth rate for the USA suggests that the economy will slow and inflation will return to its target. The 3-month annualised rate has picked up thanks to Money Market Mutual Funds and a modest pick up in bank credit. In China, at around the 5% mark, the money growth rate looks sustainable and robust. The annualised growth rate suggests that inflation will turn positive, and growth will support the rest of the world. Global inflation will be moderated by China's export deflation, which lowers the price of traded goods. Within the Eurozone, monetary growth remains weak, indicating plenty of scope for interest rate cuts in the coming months despite seeming reluctance to act. Japan has seen the 15th or 16th consecutive year of a population decline (it fell 950,000 last year alone). Japan is experiencing what happens to interest rates in a country with an ageing and declining population. Despite a recent surge, Japanese credit and money growth is deficient and does not necessarily signal an end to negative interest rates. Regarding India, however, monetary growth is in the high single digits, which is not inflationary for an economy growing at a 6-7% annual pace.

In summary, the global monetary backdrop is consistent with a soft landing, continued economic recovery, and lower inflation rates, so the big policy message is the scope for further cuts in interest rates.

Global headline inflation is falling. That is because energy prices, gas, food, and grain prices have all dropped. However, core inflation, which excludes food, energy, and seasonal stuff, is also falling. For most G30 economies, inflation is expected to fall throughout 2025. The conclusion is that cuts in global central bank interest are expected. Market rates will respond according to the structure of the respective markets.

He concluded by stating that the picture is one of interest rates declining globally. The implications for growth are positive and supported by global composite PMI indicators, which are particularly strong for India. The one area that is lagging is the Eurozone.

There is still excess saving in the system (defined as the difference between the cumulated sum of savings since 2020Q1 and savings that would have occurred measured as the average over 2015-2019). It has been run down rapidly in some countries, such as the USA, partly explaining its faster growth rate than in other G7 economies.

The global growth recovery is set to be widespread and led by the EMEs. All the G20 countries except Argentina are expected to expand this year. However, significant short-term risks to trade and energy supply remain. Conflict in the Middle East poses risks to oil exports. Trade tensions between China, the EU, and the USA have elevated.

There has also been a marked change in trade patterns. Japan is trading more with the rest of Asia than China compared with before. In contrast, the EU is now trading more with China than it used to. The USA has shifted away from trading as much with China and increased its trading with the rest of Asia and the rest of the world. Shipping is moving around the Cape instead of Suez, influencing producer costs.

Trevor Williams said that a further point of note is that global debt levels are higher today than in 2007. Debt service costs for the public and private sectors have risen, leaving little flexibility for absorbing future shocks. However, the good news is that the emerging picture is that interest costs are on the way down.

UK Monetary Conditions

Money supply growth is still clearly contracting, and the simple association of M4 growth advanced 18 months shows a strong correlation with the fall in inflation. The extrapolation of the trend in CPI is that inflation can be expected to continue to fall below the 2% target. Credit growth for individuals is weak, and lending secured on dwellings is also weak. The picture for net finance could be better. The six-month average of net finance raised by the non-financial companies from the capital market was -£2.1bn, and in February was -£5.1bn. Lending to business has fallen as loans are being repaid, especially by SMEs.

He said that as a result, firms are struggling to maintain profit margins and productivity, although service sector margins are doing better than manufacturing. However, consumer price inflation is falling faster than the Bank of England expected. The March annual retail price inflation outcome was 3.2%, but the game changer will be the April figure, released on 22nd May, when inflation could - and should - undershoot the 2% target. He said that financial markets expect interest rate cuts this year, but he forecasts that rates will fall faster than those current expectations.

An examination of the monthly growth rate of GDP shows slow growth. Still, the average loan rate paid by household borrowers shows high borrowing costs relative to the ability to pay. Nevertheless, survey data show an improving trend for industrial activity. The CBI order book balance has improved. This was confirmed by stronger-than-expected GDP and PMI data for February. So, the economy is on a recovery trend. The Bank of England's forecast of 0.75% GDP growth for the current year looks achievable.

To conclude, Trevor Williams said the Bernanke Report is a devastating critique of the Bank of England's performance. The Bank needs to reform its forecasting, pay more attention to money supply data, focus on scenarios that challenge its central view, invest more in systems, and communicate better.

Global monetary data show that the US has a soft landing in broad money growth, which aligns with a sustainable lower inflation rate. China's growth rate looks robust; inflation will likely rise, and growth will increase despite concerns about the property market.

The Eurozone can start to cut rates with a sustainable rate of broad money growth. Japanese broad money growth is consistent with the modest recovery its economy has had and with an attempt to reverse the long period of negative interest rates. India's monetary backdrop suggests strong growth inflation is likely to pick up.

The world economy is recovering and is having a soft landing despite the risks. Remarkable resilience has been shown, but risks remain.

The cost of borrowing for households and businesses is too high and needs to be lowered. That's why they are repaying debt rather than investing, helping productivity growth to remain weak.

Despite this, economic recovery is underway but will be modest. The revision to 0.3% growth in UK GDP in January and the 0.1% increase in February reversed the fall in the second half of last year. The economy should grow this year by around 3/4 of a per cent, and it is on track for growth to be above 1% next year. That is consistent, though, with significant cuts in interest rates, which are too high for the UK's current economic situation.

Interest rates should be cut before inflation falls below target; therefore, significant cuts are coming given they might not be. A rate of 2% by the end of next year would be entirely consistent with the UK's growth profile and inflation path. However, based on what the MPC may do rather than what the data suggests it should do, it may be more like 3% instead.

He said that he votes that the Bank rate should be cut by 1% immediately (in anticipation of the CPI being under 2% when the May data are released) and then by half a per cent at each of the next quarterly meetings to get rates down to 2 1/2% in 2025. That pace is fully justified by inflation running on average at the 2% target or below and economic growth of just 1/2% to 1% for this year and likely next.

Discussion

Andrew Lilico said that when the Bank raised rates to 5.25% they said that inflation would be much higher than what actually transpired. Inflation is now going to fall to much lower than what the Bank originally expected. He posed the question why the Bank does not feel a sense of urgency about having got it wrong and cutting rates sooner? He asked Roger Bootle if he could explain the Bank's thinking.

Roger Bootle said that he suspects that the Bank is monitoring average earnings which is a lagging indicator. He said that if the path of inflation is as the way Trevor has stated, and he agrees with him, then that will have huge effect on wage negotiations. That will put huge pressure on the Bank to act sooner. The other thing is that there may be some in the Bank who are looking at the sluggishness in the fall in US inflation as an indicator of what could happen here. But the UK economy is different in that the US economy is growing rapidly while the UK is not growing at all. He said that we should expect a divergence in the rates of inflation of the two economies. He said that his explanation for the bank's thinking is that it pays excessive attention to the increase in earnings. He said that they will be forced to abandon its position as the reality of very low inflation dawns. He said that he thought that interest rates were travelling down to 4% by the end of this year, and down to 3% by the middle of next year.

Philip Booth said that wages are a lagging indicator. They reflect inflation expectations. For a time when inflation was rising real wages were falling, so it is not a surprise that when inflation is falling real wages would be rising. He said for the Bank to focus on wages is just to repeat the mistakes of the 1970s. This is not just a specific mistake of modelling variables badly; it is a mistake in kind: focusing on the wrong variables because they are the variables which are easiest to measure and model rather than those variables which inherently affect inflation. It is a serious error.

Andrew Lilico said that there has been a long period of negative money growth but the worst that has happened is a 0.1% contraction in output and inflation likely to undershoot the target. The monetary contraction has not resulted in the disaster we might have expected. He asked if this is a problem for the way we view the effect of money even allowing for the long and variable lags.

Patrick Minford said that Bank policy has caused huge monetary instability. It goes against everything we understand that underpins stability which is the steady growth of money and credit. The Bank is taking enormous risk allowing negative monetary growth. As balance sheets are under heavy strain it is hard to know where the next crisis could pop up. Referring to the Bernanke Report he said that it highlighted the fact that the Bank does not look at past developments in money and credit. The models they use don't include money and credit.

Peter Warburton said that he would push back on the prospect of global disinflation. He said that we have enjoyed a lot of the disinflation in global goods prices but there are threats from global food prices from damaged crops. Given the geo-political threats circling around the Middle East he said that it would be a miracle if there were no threats to international oil and gas supplies. He said disinflation in the emerging world has stopped and inflation is rising in Russia and India and obviously Argentina. The US economy is running too hot and storing up domestic inflationary pressures. He said that he was not optimistic about global disinflation.

Patrick Minford said that it would be wrong to base monetary policy on possible shocks that may occur but have an expected value of zero. While Peter Warburton may be right about the threats and potential shocks, interest rates cannot be kept high on a precautionary basis. Policy must be based on the current situation.

Peter said that he was not advocating keeping interest rates high on a precautionary basis but that given the uncertainty of the inflationary environment and the weakness of the UK economy it is imperative that interest rates be reduced.

John Greenwood said that on the Bernanke Review what was excluded was any discussion about the type of models used. Since the models used would be designed by the permanent staff of the Bank, he said that he held no hope for a major revision from them. Clearly the Bank has a Phillips curve type orientation that has no foundation from a Monetarist perspective. Second-round effects only matter if the Bank accommodates the higher wages through loose monetary policy. He said that on the puzzle as to why negative monetary growth has not had the expected effect on real GDP, this is to do with the overhang of excess money that was accumulated during the period of excess growth.

He said that the argument that China exports disinflation is wrong. The China effect is on relative prices. During the noughties and the 2010s goods prices were typically falling at -1% but service prices were rising by 3% giving an outcome that hit inflation targets. In the period before China participated in the world economy, goods and services prices tended to move together.

Andrew Lilico said that he was conscious that people had to leave early and asked if the meeting to move to a vote with Roger Bootle to start.

Votes.

Votes are recorded in the order they were given.

Comment by Roger Bootle

(Capital Economics)

Vote: Hold Bank Rate.

Bias: To cut.

Roger Bootle said that he wouldn't cut immediately but that the bias very strongly to cut. He said that he wanted to see that the inflation figure turning out as low as he thinks it is going to be and Trevor thinks it's going to be. No change for the time being, but a very strong bias to cut and what's more, to carry on cutting too.

Comment by Philip Booth

(St Marys University)

Vote: To cut Bank Rate by 75bps.

Bias: No bias.

Philip Booth voted for a cut of 75bps. The rationale is the continued low level of monetary growth and, therefore, the need to change policy from one designed to disinflate rapidly to one more designed to disinflate slowly or perhaps not at all. At current levels of inflation, a policy stance designed to disinflate rapidly is a high-risk policy.

Comment by John Greenwood

(International Monetary Monitor)

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

Bias: No bias.

John Greenwood said he voted for a cut of 1/2 percent, but the important thing is to emphasise getting onto a trajectory of steady money growth. With the current MPC, he said that he sees no prospect whatsoever of that happening. Nevertheless, that is the right thing to do for the same reasons that Philip gave. It's too dangerous to allow money growth to continue to decline and risks deflation in 2025 or 2026. He said that QT should be stopped. His view is that the QT and QE have symmetric effects on the money supply and one of the reasons for negative money growth is the continuation of QT. The only case for QT to continue is if bank lending was strong enough to offset it and that is not the case.

Comment by Patrick Minford

Cardiff Business School, Cardiff University)

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

Bias: to keep cutting with a further 50bps.

Patrick Minford said that he agreed with John Greenwood and that we should cut rates until monetary growth stabilises at some steady state. Policy needs to get back to a stable environment. There's huge risk now with money growth negative the impact could be incredibly dangerous. He said that this is the biggest worry. The instability that the Bank has created. We need to get back to a stable environment and that means now cutting rates to encourage a return to stable money growth which is in the order of 4-5% growth. He said that QT should be suspended as it was contradictory to continue with QT while cutting rates.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: To cut Bank rate by 50bps and end QT

Bias: To cut to 4% by the end of the year.

Peter Warburton said that an immediate half point cut in Bank rate is justified. Given that fixed rate mortgage rates have risen by 30-40 bps since the start of the year there is a need to offset some of the tightening going on in international markets. He said that he agreed with John Greenwood and Patrick Minford about QT. He said that he did not understand why QT should be continued. A sound rationale was never provided for this strategy in the first place or why it should be £100bn a year. He said that QT should be abandoned. He added that he had a bias that rates should come down to about 4%, but a 50 bps is needed immediately. He said that he had a weaker growth outlook than the consensus and that the economy could fall back into recession later in the year.

Comment by Andrew Lilico

(Europe Economics)

Vote: to cut Bank rate by 50bps. Suspend QT

Bias: Strong bias to cut further

Andrew Lilico said that he had some sympathy for the position of continuing with some form of QT along with rate cuts. He said that the rationale is fiscal. He said that the Treasury took profits from QE and indemnified the Bank's losses. This is added to the government's budget deficit. We are heading for a fiscal crisis. In this environment it is better not to accumulate further bond losses from QT. He said that he was uncomfortable with the position of a drastic monetary contraction and with no drastic impact on the economy. He said that he did not think that interest rates should be cut with the same level of QT. He said that a 50bps cut is warranted but with half the level of QT.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

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

Bias: To cut.

Kent Matthews said that he agreed with John Greenwood's explanation as to why the lag in effect is longer than normal. This is because of the overhang of the precautionary holding of money. There is still a stock adjustment going on which is showing up in a flow contraction. But John Greenwood made a clear prediction that if the flow contraction was not reversed there will be a recession in 2025-26. This is a longer than normal lag in effect but explicable in terms of the overhang. He said that the relatively optimistic view about the economy presented by Trevor is inconsistent with his expectation that the Bank will not lower interest rates as fast as he said they should. He said that he has sympathy with the view proposed by John that recession in 2025 is possible if the rate of growth of money is not stabilised at a low positive rate. To this end he said that QT must be halted to help in reversing the trend in money supply growth.

Comment by Trevor Williams

(University of Derby, TW Consultancy, and FXGuard)

Vote: Cut Bank rate by 100bps. Scale back QT if rates are not cut immediately.

Bias: To cut

Trevor Williams said that the economic recovery is underway, and monetary growth is improving but still negative. However, the Bank of England should cut the Bank rate by 100 bps immediately, with further cuts bringing it down to 2.5 per cent in the next year or so. He said he did not think the Bank would behave this way, but such a pace of rate cuts would be entirely justified by falling inflation and weak economic growth of under 1%. He has consistently voted that QT should cease until rates are cut. However, as he thinks that the debt mountain has distorted investment decisions and has other harmful side effects, QT should continue to be scaled back in the event of the rapid pace of rate cuts he has suggested.

Comment by Graeme Leach (in absentia)

(Macronomics)

Vote: To cut Bank Rate by 75bps. End QT

Bias: bias to cut.

Graeme Leach voted to cut Bank Rate by 75bps and end QT. The weakness of broad money growth in the UK economy justifies an end to QT and a significant reduction in interest rates of 75 bp. M4 broad money supply growth in the UK is close to zero and negative in real terms. Not for the first time the Bank of England is too slow responding to monetary conditions, and complacent about the impact of money on the economy. QT should be suspended at the very least and not resumed until broad money growth is sustainable in the 5%-6% range. We are a world away from this situation, with systemic issues in the banking systems in the US and China an ongoing threat to global financial stability.

Any other business

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

Policy response

1. There was a majority agreement that monetary policy needed to be loosened.
2. A majority of the committee voted to cut Bank rate by 50bps immediately.
3. One member voted for an immediate cut of Bank rate by 100bps and another voted to cut by 75bps.
4. One member voted to hold Bank rate pending information on the inflation rate.
5. There was a majority agreement to halt QT and to stabilise the rate of growth of money in the 4-5% region.

Date of next meeting

9 July 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).