Minutes of the meeting of 15 August 2024 Institute of Economic Affairs (hybrid meeting)

Attendance: Philip Booth (online), Juan Castaneda, Tim Congdon (online), John Greenwood (online), Julian Jessop (online), Graeme Leach (online), Andrew Lilico (Chair), Kent Matthews (Secretary – online), Trevor Williams, Patrick Minford (online), Peter Warburton (online)

Apologies: Roger Bootle

Chairman's comments: Andrew Lilico welcomed members online and invited John Greenwood to present his assessment of the economic and monetary situation.

Monetary policy is about the rate of growth of the quantity of money

John Greenwood began his presntation by quoting Milton Friedman. 'Monetary policy is not about interest rates. It is about the rate of growth of the quantity of money'. He said that an economy can experience low rates and high money growth and as in the case of Japan, low rates with low money growth. For that reason the interest rate is not a good indicator of monetary policy. He said that his presentation will first cover the international monetary environment and second the UK monetary environment. He said that there have been several *ad hoc* explanations of the cause of inflation and mentioned three popular ones. The first is fiscal support measures such as the furlough scheme. He said that fiscal spending is not stimulatory unless financed through the banking system. The second is that interest rates have been kept too low for too long. He said that central banks have paid far too much attention to rates and yields and not enough to the quantitative dimension of monetary policy and ignored the rapid growth of money in 2020-21 due to QE. The third is the labour shortage argument due to workers not returning to work after pandemic. He said that total spending is determined by money growth and income velocity. Recent papers by Bernanke and Blanchard look at the components of the change in prices but this does not explain the underlying cause of inflation. In his view the only cause of inflation is excess money growth. He described the monetary transmission mechanism as the impulse from monetary growth working in three stages. Stage 1 is from monetary growth to asset prices which takes 1-9 months. Stage 2 is to economic activity which takes 6-18 months from the initial impulse. Stage 3 is to goods and services prices which takes 12-24 months from the initial impulse.

High broad money growth rates in the US, UK and eurozone during the pandemic have given way to low and sometimes negative money growth. There has been some revival but money growth remains low. He said that the difference between QE in the GFC and the Covid period was that banks balance sheets were impaired in the former period. Regulations and capital requirements caused a freeze on lending, and QE only partially compensated for the lack of broad money growth. In the Covid period, banks were in good shape and QE had a much more powerful effect in driving up broad money growth.

He said, in contrast, there has been moderate money growth rates in China, Japan, and Switzerland. In Japan it came from an increase in bank lending not QE. In Switzerland it came from purchases of foreign securities. In China and also India there was no QE. Money growth in China has slowed to half of what it needs to be which is 10-12% growth a year for a 3% inflation target. In Japan and Switzerland broad money growth is 1.1% and 1.3% respectively. John Greenwood said that globally what is happening is a disinflationary momentum.

He said that it is important to view the charts of money growth of China, Japan, and Switzerland, because the narrative pushed by central banks is that inflation is a global phenomenon. The evidence from these countries proves otherwise. Indexing the price level to March 2020 shows that the price level for US, UK, and Eurozone has risen 20-25%. For Japan it has been 8%. For Switzerland it has been 6-7%, and China has seen deflation. He said that going forward, the international environment is one of disinflation or even deflation.

John Greenwood referred to charts of nominal GDP and broad money growth with money growth shifted 18 months forward for the major eonomies. There is a close correspondence for the Covid period but the gap between the two growth measures prior to Covid is explained by changes in the income velocity of money. Countries (US, UK, Eurozone, Canada, Australia, New Zealand, Israel, Sweden) that conducted QE during the Covid period will experience a slowing down of their economies as money growth slows. Similar charts for the low inflation countries that did not see money growth rise in the pandemic period (Japan, China, Switzerland, India) suggest that monetary growth remaining low will create disinflationary or deflationary pressure. Global commodity prices reflect the pattern of rapid growth and slowdown in broad money, as does nominal retail sales in the US and exports in USA, China, and Eurozone economies. This summarizes the monetary environment in the international picture which he said is one of slowing nominal GDP growth.

UK Monetary Environment

Turning to the UK, John Greenwood said that he will use the same structure as in his analysis of the global economy to analyze the UK monetary environment. Following the transmission mechanism outlined earlier he said that he will first describe the pattern in money holding and income velocity. Next he will move on to housing prices as representative of asset prices. Following on will be economic activity, the labour market, and finally inflation.

Monetary growth in the UK had increased in the Covid period but as the economy was in lockdown excess money balances had built up (i.e. velocity had declined) but with the recovery of the economy household spending had picked up and income velocity had now returned to its pre-Covid trend. So, there is no more excess money in the system driving up inflation. Looking at UK house prices, John Greenwood said that the acceleration and slowdown follows the same pattern as money growth. Turning to economic activity, John Greenwood said the post-Covid bounce back has been replaced by a sharp slowing in nominal GDP growth consistent with monetary contraction. Real retail sales in the UK had slowed and capital spending had remained sluggish. In the labour market the ratio of vacancies to unemployment, which measures labour market tightness, has eased to pre-Covid levels and similarly wage growth is moving back to pre-Covid levels.

John Greenwood referred to the chart of a fiscal policy measure given by the ratio of total managed expenditure as a % of GDP, and nominal GDP, and M4 growth. He argued that austerity in the GFC period was not caused by fiscal policy but by inadequate money growth. He said that austerity can be avoided post-Covid by adequate money growth.

He summarised his position on the global environment as still not buoyant and that broad money growth rates remain below normal. Nominal GDP in the international economy is likely to slow in the coming 18 months due to the prior broad money slowdown. In the UK, broad money growth has been too low but is recovering and needs to accelerate modestly. Increased fiscal spending is tolerable provided it is not financed through the banking system. He concluded by saying that Bank rate should be cut by 0.25%.

Discussion

Andrew Lilico thanked John Greenwood and said that to start the discussion off he would pose the question would a large reduction in potential output caused by a natural disaster be inflationary? John Greenwood said that the pandemic was an example of such a shock but the recovery in potenttial output returned the economy to it pre-Covid position and that persistence effects are small relative to the monetary shocks.

Trevor Williams said that supply shocks are significant and would contribute to inflation. He said demographic factors (a falling working age population) will and is reducing UK potential output. John Greenwood said that demographic factors are small against 10-20% movements in the money supply. Andrew Lilico clarified his comment and said that an oil price shock can be inflationary not from the direct effect on the price level but from the effect of a fall in output.

Graeme Leach said that the implication of John Greenwood's analysis is that world is heading for a serious recession. He said that he remained particularly concerned about China where M3 growth has halved and the property sector in serious trouble which the recent stimulus package will not resolve. John Greenwood said that that was what he expected for the USA until he realised that the excess money in the system was used to support the economy in 2022-23. That excess money has now disappeared. While money growth has been low it is now picking up and with central banks cutting rates hopefully this will stimulate money growth. He said that he agreed that China is in a monetary tangle because they have dropped the language of monitoring money, to which they used to pay a lot of attention and now focus on the rate of interest as the instrument of monetary policy. Money growth in China needs to be double what it currently is and cutting interest rates by 10 or 20bps will not do it.

Patrick Minford said that while he accepted that there is a strong correlation between money growth and inflation he did not accept that everything in the macroeconomy could be explained by money alone. The economy faces both real and nominal shocks and central banks operate on the rate of interest and that we need to understand the world through the operation of interest rates.

Julian Jessop said that looking at M4 growth for households tells a different story. Household M4 growth is close to 5% and doesn't look too unhealthy. Kent Matthews said that he did not understand John Greenwood's point about the seperation of interest rate and money. How does he come to a cut of 25bps and not zero or 50bps? Juan Castaneda said that he very much concurred with John Greenwood's assesment and said that he votes for a 25bps cut in Bank rate. His reasoning is that the rate of interest influences bank lending and other things being equal increases broad money. John Greenwood said that he did not imply there was no link between the rate of interest and money growth, he said that the rate of interest is an imperfect measure of monetary stance. He said that current policy is contradictory as it is contractionary on the quantity position through QT but expansionary on the interest rate position.

In reply to Patrick Minford, John Greenwood said that the analysis of Blanchard and Bernanke decomposition of inflation in the pandemic does not take into account the large movements in broad money. Patrick Minford agreed that the monetary shocks should have been included but those models have been tested empirically and they have good explanatory power whereas, correlations of money growth and nominal GDP growth are only correlations.

Tim Congdon said that in relation to the Blanchard-Bernanke study the rise in the UK's import price deflator in the four years to mid-2024 is much the same as the rise in the UK's GDP deflator. There was nothing particularly special about external shocks in the Covid period at all. He said that he did not dispute that there were some shocks in 2022, but they were really transitory.

Philip Booth said that real shorter-term interest rates are historically high (compared with the last 15 years) and much higher than long-term real interest rates and so there has to be a good story offered as to why real interest rates of the current order of magnitude should remain so high. He said that he would propose a 50bps cut in Bank rate but had no view on QT.

John Greenwood reminded the committee that the MPC had voted to extend QT by £100bn for the 12 months October 2024 to September 2025 rest of the calendar year. He said no matter what the Bank does with the rate of interest, the path of inflation for the next few quarters has been determined from the past rate of growth of money.

Trevor Williams said the real shocks matter and that growth rates 2-3% are not sustainable because of demographics and other real shocks. He agreed that money growth is insufficient and that monetary policy must be loosened. He said that he would vote a cut of 50bps in November and a further cut of 25bps in December and to continue with QT.

As members of the committee had started to give votes, Andrew Lilico formally invited the members 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 25bps. Stop QT.
Bias: No bias.

John Greenwood said he made his vote clear in his presentation. For him the principal objective is to maintain M4 growth in the order of 4-5%.

Comment by Juan Castaneda

(Vinson Centre, University of Buckingham)

Vote: Cut in Bank Rate by 25bps. Stop QT.

Bias: No bias.
Juan Castaneda concurred with John Greenwood's monetary analysis of inflation. He said that the current annual rate of growth of broad money (M4x) is still too low (1.8%, August 2024 data). In order to achieve the 2% inflation target over the next 1-2 years, M4x growth should stay in the range of 4-5% per annum. Therefore, to increase the rate of growth of money the Bank should cut down the policy rate and stop quantitative tightening (QT). Other things equal, with a lower policy rate banks will be more willing to lend, which creates bank deposits (i.e. money). In this context, keeping QT would be unadvisable and contradictory, as QT withdraws money from the economy.

Comment by Philip Booth

(St Marys University)

Vote: To cut Bank Rate by 50bps.

Bias: No bias. No view on QT.

Real interest rates are high by recent historical standards and short-term rates much higher than long-term rates. Rather than explain the dynamics of real interest rates falling in stages to normal levels there has to be a good story as to why they remain high. He said that he had not thought enough about QT to give a view.

Comment by Trevor Williams

(University of Derby, TW Consultancy, and FXGuard)

Vote: Cut Bank rate by 75bps

Bias: To reach 4.25% by the end of the year. Continue QT

The Central Bank should not be in the business of financing government debt by buying its stock, even from the private sector aside from emergency situations or to smooth financial market volatility. Then there is the dividend which adds to the government debt burden which reduces its spending on other items of public spending. He said that in his view, there is a theoretical point about the 'zero bound of interest rates'. When nominal official interest rates are cut to zero, QE allows further monetary loosening by buying government debt but if the central bank is already holding large amounts of government paper it adds to the risk of removing flexibility to respond to future crises without ratcheting debt to ever higher levels. Better to get the stock of debt down via QT If an offset to implied tightening is seen as a risk, better to lower short term rate to compensate

Comment by Graeme Leach

(Macronomics)
Vote: To cut Bank Rate by 50bps. End QT
Bias: No bias.

Graeme Leach said that we should not be surprised that a hard landing hasn't yet occurred in the US, but we should expect one in 2025. A number of factors explain the resilience of the US economy to date: (1) The scale of the monetary overhang from 2020-21. (2) The forced savings build-up during the pandemic, and subsequent drawdown. (3) The scale of fiscal stimulus at near full employment. He also pointed out that recessions don't directly follow the inversion of the yield curve, but only subsequently, when the yield curve begins to un-invert. This is another reason why we shouldn't have expected a recession before now. The Sahm Rule also provides a signal on the timing of the recession from now onwards. The Sahm Rule relates a forthcoming recession to when the three-month moving average of the national unemployment rate rises by 0.50 percentage points or more relative to its low during the previous 12 months. We are seeing the beginning of this effect now. The US monetary slowdown in 2023 and weakness of current broad money growth in the US (albeit improved) also signifies a hard landing is baked in the cake. These indicators suggest that the US economy will fall into recession in 2025 and the hard landing will be intensified by problems in the banking system, and a likely unprecedented simultaneous hard landing in China. All these influences will combine to pull down global interest rates, and in the UK also over the 2025-2026 period.

Comment by Julian Jessop

(Independent Economist)

Vote: Cut in Base Rate by 50 bps. Pause on QT.

Bias: No bias

Julian Jessop said that there has been no mention of the coming budget which will see a tightening of fiscal policy. An expected rise in employee's contribution will have the same effect as a tax rise. This tightening needs to be offset by a monetary loosening. Regarding QT he said there is a need to pause for rethink about the full implications in the long term.

Comment by Patrick Minford

f Business School, Cardiff University)

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

Bias: No bias.

Patrick Minford said that he agreed with Philip Booth and Julian Jessop that the rate of interest needs to come down quite a lot. He said that he takes a slightly different view on the issue of QT. The operation of QE/QT was designed for the zero-lower bound. QT is only effective under the zero bound. In normal times rates are set by the Taylor Rule and at the long end by expectations. Now we are not at the ZLB and the Bank is operating on the rate of interest, he said that he agreed with Trevor Williams that the debt held by the banking system needs to be removed so that if there is another crisis, we may have to restart that programme and then the ZLB will matter. Long term rates are determined by the expectations of future short rates and this will not be disturbed by QT. So, QT should continue.

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)

Vote: To cut Bank rate by 50bps. Halt QT

Bias: No bias.

Tim Congdon said that he is in favour of cutting rates by ½%. Broad money growth is very low but he added the caution that money growth of 3-4% in the medium is what is needed to hit the inflation target. As a concession, he added that he had been wrong about the effect of the fall in real money balances on growth.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To cut Bank rate by 50bps and end QT
Bias: No bias.

Peter Warburton said that Tim Congdon had nothing to apologise about. The economy has recorded a technical recession, and as the population has grown faster than GDP, there is a GDP per capita recession. He said that an examination of the last five years' data shows that there has been no contribution to GDP from the private sector. It has all come from the public sector. Regarding the monetary context, he said that the broad monetary aggregates must be examined in conjunction with their credit counterparts. He said that there has been a significant deleveraging of the UK household sector. The demand for credit is being scaled back, the growth of credit card debt has slowed dramatically, and the household saving ratio has risen from 4.5% to 10%. There is a sharp increase in debt delinquencies and bankruptcies. He said that the recent acceleration in monetary aggregates is not driven by lending growth to the private sector. Commercial banks are preferring to acquire gilts, instead of lending to households and businesses. He said that his analysis fits in with concerns for the UK economic outlook voiced by Graeme Leach and Philip Booth. He said that interest rates are too high. If higher taxes are overlaid on to this picture, he said the economy is likely to experience a prolonged recession. He votes for a 50bps cut in Bank rate, cessation of QT and time for a rethink of Bank of England.

Comment by Andrew Lilico

(Europe Economics)
Vote: to cut Bank rate by 50bps. To continue QT
Bias: to cut further

Andrew Lilico said that the Bank of England has blundered. They have allowed money supply growth to be too low for too long. He said that this will lead to an undershoot in nominal GDP and hence an undershoot of the inflation target. Precisely how the nominal GDP undershoot breaks down between inflation undershoot and low GDP growth or recession will depend on a number of other factors. The Bank has missed the chance to avoid a very difficult period over the next year or so. Looking further ahead into the main period over which policy changes now would have a chance to have an effect, he said that monetary figures don't look so bad that it requires emergency action. He said that he would be content to see a 50bps cut in rates. He said that he agreed with Philip Booth regarding the relationship between short-term interest rates and gilts yields and if the monetary figures were worse he would be advocating a 75bps cut. But for now, a 50bps cut will suffice and wait and see the effect, and continue with QT.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

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

Bias: No bias.

Kent Matthews said that whether you believed the economy is dominated by real shocks or monetary shocks is unimportant to the policy recommendation that either broad money growth is too low or real interest rates are too high. Whether the inflation surge was caused by an increase in broad money growth driven by monetary shocks or a decrease in demand for real money balances caused by real shocks is unimportant. Inflation was caused by excess money. Similarly, whether broad money growth is too low relative to demand or the demand for real money balances is too high relative to supply, is also unimportant to the policy recommendation. He said that some theoretical modelling he had done in the past with a disequilibrium model of money indicated that when the demand for real balances is in excess of supply, a situation consistent with Peter Warburton's analysis, the rate of interest needs to fall rapidly if the disequilibrium is not to be translated into a fall in output. Regarding QT, he said that he was uncertain what the policy should be. He did not think it should be abandoned but a pause to allow the cut in short rates to work through to the bond market without disturbance from the Bank's QT policy is warranted and he would like to see a pause.

Any other business

Julian Jessop enquired if there had been any response from the Bank of England to the request for a meeting? Andrew Lilico said that the response was that they would discuss it internally.

Policy response

In keeping with tradition, in the case of attendance being greater than the required number of votes of 9, the views of the members that joined the meeting last will be recorded but not counted.

1. There was a unanimous agreement that monetary policy needed to be loosened.
2. A majority of the committee voted to cut Bank rate by 50bps immediately. Two members voted for a cut in Bank rate by 75bps. Two members voted for a cut in Bank rate by 25bps
3. There was no consensus on the future of QT. The opinions ranged from halting (4), pausing (2), to continuing with QT (3). On the basis of common ground, the committee recommends a pause in QT activity.

Date of next meeting

14 January 2025

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).