

# Minutes of the meeting of 14 January 2025 Institute of Economic Affairs (hybrid meeting)

**Attendance:** John Greenwood (online), Graeme Leach (online), Andrew Lilico (Chair), Kent Matthews (Secretary), Trevor Williams,

**Apologies:** Philip Booth, Jamie Dannhauser, Julian Jessop, Patrick Minford

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

## International Outlook

Trevor Williams drew the committee's attention to the first slide of his presentation, in which he showed the latest IMF and OECD projections for growth for the major economies, including China, India, and Brazil. Both organisations say that the growth spurt expected in 2025 will not be sustained and will slow in 2026. He said this is roughly what the Bank of England and OBR are saying about the UK.

Except for the USA, all the industrial countries are growing at roughly one-third of the expected world economy's annual average growth rate. The US economy is expected to grow at roughly two-thirds of the world's growth rate. The UK is expected to outperform the Eurozone in 2025 and grow not far off the Eurozone average in 202, according to the IMF and OECD. The world economy is above the pre-pandemic level – the UK less so than the Eurozone.

The country that has outperformed all has been the US, which is 11 per cent higher than its pre-pandemic peak. He said that we know why this is. The US is energy-sufficient. They have the total oil and gas production of Saudi Arabia and Russia combined. The US share of global gas and oil production is 23 per cent, though they consume most of it.

Turning to the domestic economic outlook, Trevor Williams said that the growth momentum in the UK has slowed in recent months but will surely accelerate. Two factors have aided the recent global recovery. First, the boost in international trade, which in 2025 should hold up despite the threat of Trump's tariffs. Second, the sharp fall in commodity prices which fed through the supply chain to lower consumer price inflation.

Trevor Williams said that what is interesting about the progress in reducing inflation pressure is that it has stalled recently and, in some countries, slightly reversed from lows. Some of this is due to year-on-year effects, and some to removing energy support measures. Much of these effects will occur in the first half of 2025, and so the second half should see inflation drop much closer to the target or below. However, service price inflation is proving to be sticky, and a revealing piece of research on Bank of England Underground looks at the reasons for this, based on lags of the different impacts, or pass through, on service firms of increases in food and energy prices compared with manufacturing firms that affects them differently or not at all.

However, we should not be surprised by the reasons why service price inflation is sticky. Goods price inflation has a quicker pass-through of input price changes to output prices than service price inflation. However, there is another reason why the peak in inflation is higher in the UK than elsewhere. Industrial energy prices in the UK are amongst the highest in the world, just as the cost of Green energy support is rising. This competitive effect on manufacturing has seen margins falling from 10-12 per cent to 7 per cent, and the UK share of manufacturing in GDP fall faster than in peer countries..

## UK Economic Environment

A survey about government policies reveals that private-sector businesses are relatively optimistic about the government's industrial strategy. The survey asks questions about the budget. Regarding the industrial strategy, the survey asks if the government is targeting the correct sectors, whether it gives confidence that firms can acquire the skills they need, whether it would help with the UK's long-term productivity problem, and whether it would increase a firm's investment. The survey shows that most firms' strongly disagree numbers are roughly matched by those with strongly disagree bias, but most firms fall in the somewhat agree and the neither agree nor disagree camps.

On the October Budget, the arithmetic is well known. Spending is up, taxes are up, and borrowing is up. Andrew Lilico asked if Trevor Williams believed whether the tax numbers were deliverable. Trevor Williams said that, of course, it will depend on growth, but he expected expenditure cuts in government in the second half of this parliament. He said he didn't think they would borrow or tax more than announced, leaving little option but to find cuts. However, taxes as a share of GDP are projected to reach a post-war high, and the OBR October 2024 projection sees it rising above the post-war peak of 37.2 per cent in 1948.

Andrew Lilico said that, whether the numbers were good or bad, he didn't think the UK economy would generate that level of taxes. Trevor Williams said that these figures are in the budget, that the budget figures are what the government is aiming for, and that only time will tell whether the tax take will hit their targets. Andrew Lilico said that if taxes rise beyond a certain threshold, there will be capital flight, the exit of high-income individuals, and the departure of internationally

mobile businesses. Trevor replied that may be so, but they could still hit the levels they predicted, which is why the capital flight might occur.

Trevor Williams said the budget figures show that the UK has moved up the international tax league table. He said we may not leap ahead of the top taxers, but we will be up there with France, Italy, and Germany. Trevor Williams said that the issue for him is that countries like France and Germany deliver better health outcomes with what they spend than we do. That is not just about health but all public services. While we may discuss why we underperform in this relative to our neighbours, the main issue is that rising taxes make us less competitive and will harm our growth rate.

The implication for the budget is that debt interest is going to be greater than £100 billion. Graeme Leach said two elasticities are significant for the UK economy, given the government spending and taxation scale. One is the elasticity between expenditure growth and taxation and economic growth. Research suggests that a 10% rise (the increase over recent decades) in the ratio of tax and/or spending to GDP could shave off between 0.5 and 1.0 percentage points of GDP growth. Second, we are in the Carmen Reinhart and Kenneth Rogoff zone, with public debt around 100% of GDP, which could shave off another 0.5 percentage points. These two factors threaten all potential output growth in the coming years, given that it is probably less than 1.5%

Trevor Williams agreed that they could threaten growth but what debt is being used for could matter and said that our role is to examine policy. In doing so, we unearth structural issues about public sector provision and private sector partnership. So, if, for instance, we were to double our defence spending to 5 per cent of GDP or £166 billion, it would be impossible without cutting elsewhere..

Trevor Williams said that the form of tax increases is weighted towards businesses. £28 billion was spent on business, NI increases, the national minimum wage, and employer pension contributions. These interventions have done damage by raising the cost of labour to firms, which means lower wage increases and fewer jobs. That will negatively impact private-sector investment, unemployment, and wage growth. However, the budget will not alter the dynamics of real disposable income growth, which from OBR projections is showing  $\frac{1}{2}\%$  increase per year over the entire parliament, which is marginally higher than what was projected under the previous budget. Pay is increasing at 2.2 per cent - adjusted for inflation - and will likely remain ahead of prices for the rest of this year. Another positive is a low unemployment rate, although that might start to pick up. Further positive news is that the employment rate has been rising since 2020.

Trevor Williams said there is a potential supply-side boost to the economy from the return of inactive labour. There are 2.8 million people out of the labour market due to illness. Before the global financial crisis, it was more about 2.3 million. So, there is the potential to get upward of  $\frac{1}{2}$  million people back into work. Also, there are still a lot of unfilled vacancies. One negative factor is that recent Home Office data shows a 42% fall in visas for care workers and students; that is a supply-side hit. In summary, although growth momentum in the UK has slowed, the forecast is that it will accelerate in the short term.

Focussing on inflation and interest rates, the actual economic backdrop suggests that inflation may tick up in the first half of this year and then decelerate in the second half. Inflation is expected to be on target thereafter. Kent Matthews asked if that forecast was based on unchanged interest rates. Trevor Williams said an assumption is drawn from market expectations for interest rates. Andrew Lilico said it was based on faster falls in interest rates than the market expects, as these projections are from the budget.

The data shows that M4X growth is weak. Looking at the link between inflation and money supply growth advanced by 18 months suggests that inflation can still decline further. This track of inflation and money growth is not inconsistent with the previous projections. We believe that money supply growth is a better inflation forecast than the record of the MPC. QT is raising yields and dampening money supply growth. Current market expectations are that the bank rate stays above 4 per cent, and long-term and mortgage rates do not fall much below current rates. Long-term interest rates have risen sharply since the 1990s, but 10-year bond spreads over Treasuries have not increased relative to the US. So, this is not a UK issue but a US issue. Bond spreads with the eurozone economies look much the same.

Trevor Williams said that Britain is borrowing more from the rest of the world. The only domestic saver are households, but that is not enough to cover the borrowing of the corporate and public sectors. So, swap rates and mortgage rates are less affected by market turmoil. Fixed rates may also contribute to the stability of the home loan market, with variable rates accounting for only 12 per cent of mortgages. Lending on secured dwellings is picking up. Firms are also borrowing. SMEs are still repaying debt, but not as rapidly a few months ago and a positive sign about confidence.

In conclusion, Trevor Williams said that inflation will drop to target over the MPC target period. The Bank should be looking to support the economy which is facing multiple challenges, by cutting rates sharply, as the UK has a growth problem, not an inflation problem. Corporates are the principal borrowers, and we need to make the cost of borrowing low so that more investment takes place and boosts productivity. He said that an international comparison of inflation, growth and interest rates shows that the Bank stands out as being too aggressive with a higher interest rate than the average. He

said he votes to cut the Bank rate by 50 bps, and that rates should be cut at subsequent meetings to reach a target of 3 per cent as soon as possible.

## Discussion

Andrew Lilico asked if Trevor Williams agreed with the numbers projected by the IMF and OECD. Trevor Williams said that while he did not agree with the exact numbers he thought that there was nothing wrong with 1-1.5% growth for the UK for the next two years. Kent Matthews asked clarification as to what was meant by 'growth spurt'. Trevor Williams said that the growth spurt is caused by the front-loading of government spending announced for the next two years. Government spending drops back to the departmental averages seen by the conservative administration, which means that in the second half of this government public spending growth will be negative creating serious problems of austerity.

Andrew Lilico questioned the value of the survey of private businesses if they had any better idea than anybody else about where the government should invest. Trevor Williams said that for what it is worth, the survey highlights the relative optimism of businesses to the industrial strategy and this may be a good thing.

Kent Matthews questioned the consistency in the OBR projections of low real personal disposable income growth and the IMF and OECD forecasts of 1.5 – 1.7 per cent GDP growth. Graeme Leach said that the saving ratio has got slack that can absorb some of the gap. Trevor Williams said that there is an assumption here that the big jump in savings in the pandemic will be run down.

Andrew Lilico said that if the OBR forecast for inflation is conditional on market expectations of interest rates and if the market is guessing what the Bank of England will do, and the Bank is conceptually wrong, the Bank could be making an epic mistake. Trevor Williams said that he did not think market expectations are based solely on what the Bank will do, but also on inflation expectations and their own opinion about economic conditions.

Andrew Lilico asked the committee to consider the news of the past couple of weeks that has been dominated by movements in the financial market of Gilt yields and the rise in long-run inflation expectations. Should that information affect the decision we make?

Graeme Leach said any rise in long term expectations was likely to readjust downwards because the chart of the association between money supply growth and inflation shows there is the likelihood of an undershoot in the inflation target over the coming year. He said that at the same time the recent spike in bond rates and the US rollover of \$7 trillion in public debt this year is a warnings sign that bond markets are becoming more sensitive to fiscal incontinence on Capitol Hill.

John Greenwood said that except for 30 year bond rates, the shorter dated bonds are in the range of inflation risk above target. He said that markets can drive yields quite a lot in the short-term and can put them out of kilter with fundamentals. But the chart of money supply growth shows that inflation will gradually fall. So this will prove to be a short-term panic. He said that like Graeme Leach he shares the concern about the long term and that the politicians on both sides of the Atlantic are not prepared to address the long term fiscal problem. At some point we are going to see a market rebellion at some stage.

A second point that Andrew Lilico made was that Philip Booth had made the point at previous meetings that the long term rate was in the 4.00-4.25 range but the short rate was much higher. He would say that in the current inflation environment of being near the target, the rationale for keeping short rates that much higher than long-term rates is unclear. He said that if you buy that kind of argument, in the past month we have seen a 100 bps shift in closing the gap so that the yield curve is now looking flat or normal. Which means that the market perception of a too tight monetary policy has shifted to a too loose monetary policy. Another point is that if these long-term interest rates are indicative of a structural shift pointing to an increase in the real cost of capital and a fall in the medium term potential output, that would be inflationary in the medium term.

He said that it is possible to think of this as temporary because in principle the government can solve the problem of the fiscal gap, but he said he believes that the government cannot solve it because of commitments to high levels of public spending, and levels of taxation the economy cannot support. So the deficit is going to be higher than what is scheduled.

Graeme Leach said that every recession in the US in the past 50 years has followed not the inversion of the yield curve but the un-inversion thereafter. The recession tends to follow the un-inversion a relatively short period thereafter. The key question now is whether this relationship will still hold.

Trevor Williams said that a further issue is the declining global population, which in consequence will see a rise in global savings. So if the US can mop up the savings to run for longer, we won't face a crisis.

Andrew Lilico said that looking at the chart of money supply growth and inflation, he asked should we think that everyone has got it wrong and that inflation is going to undershoot the target. That the Bank of England should have cut interest rates earlier as we had been telling them. But bygones are bygones, and that we are now moving to a situation where in 18 months time as monetary growth has improved there is not much reason to loosen now.

Trevor Williams said that 60% of the past tightening has not come through and for that reason also inflation will fall below the target if rates are not cut sharply.

John Greenwood said that first, the slowdown in monetary growth in the past 18 months will exert a slowdown in inflation in the next 18 months, and second the pick up in M4 growth in recent months is still well below the 4-5% range needed to hit the inflation target of 2%. So, in his view there is scope for rates to be lowered. He said that regarding long-term rates, this is the market reacting to signals which it may or may not be interpreting correctly.

Andrew Lilico said that we have Trevor Williams's vote and he called for the others to vote.

### **Votes.**

Votes are recorded in the order they were given.

### **Comment by Trevor Williams**

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

**Vote: Cut Bank rate by 50 bps**

**Bias: To reach 3.00% with quarterly successive cuts and to continue QT**

Trevor Williams said that inflation will drop to target over the MPC target period because of weak money supply and that some 60% of the past tightening of rates has yet to impact the economy. The Bank should be looking to support the economy as the UK has a growth problem, not an inflation problem. Corporates are the principal borrowers, and we need to make the cost of borrowing low so that more investment takes place – counteracting some of the negative effects of the tax raid, and boost productivity. He said that an international comparison of inflation, growth and interest rates shows that the Bank stands out as being too aggressive with a higher interest rate than the average. He said he votes to cut the Bank rate by 50 bps, and that rates should be cut at subsequent meetings to reach a target of 3 per cent as soon as possible.

### **Comment by Graeme Leach**

**(Macronomics)**

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

**Bias: No bias.**

Graeme Leach said that he was a little surprised that inflation had not fallen back further already given the slowdown in monetary growth. But he still thinks the chart of inflation and money growth will continue to apply and so we can expect a further slowdown. He said that inflation will undershoot the target, and we can justify a 50bps cut in rates. Annualised M4 growth is only 3% and a cut in rates is justified without any risk to inflation.

### **Comment by John Greenwood**

**(International Monetary Monitor)**

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

**Bias: No bias.**

John Greenwood said he would like to see a modest acceleration in money supply growth. To facilitate that he said there should be a cut in the Bank rate of 25bps and that QT should be suspended as that hinders money growth.

### **Comment by Andrew Lilico**

**(Europe Economics)**

**Vote: to cut Bank rate by 25bps. To continue QT**

**Bias: to cut further**

Andrew Lilico said there is likely to be an undershoot of inflation in the short run. The chart of inflation and money growth show that there is a lag in effect. But the sharp drop in money growth is so big that it suggests that inflation will undershoot. He said that he expects a contraction in GDP in the first quarter of next year or at least very slow growth. He said that the economy is heading towards a fiscal crisis and the Bank of England should not act to make that fiscal crisis less likely. He said that the fiscal crisis is a necessity, and the Bank of England should not make it easy for the government by playing politics. For that reason, he said that the Bank should continue with QT. If the fiscal crisis is not resolved, then there is the risk that inflation in the medium term could rise and there is a non-trivial chance that the inflation target gets raised to 3%. Until we see an improvement because of the fiscal crisis, the better assumption is that it will be inflationary and that reduces the tendency to cut the rate of interest.

### **Comment by Kent Matthews**

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

**Vote: To cut Bank Rate by 25bps. To pause QT.**

**Bias: No bias.**

Kent Matthews said that there is reason to be cautious this time round. At the previous SMPC meeting, he along with most of the committee voted for a 50bps cut in Bank rate. Caution is dictated partly by the change in inflation expectations which is signalling inflation uncertainty. This in turn could come from an 'unpleasant monetarist arithmetic' story of the Sargent and Wallace kind, where although current money growth is signalling a fall in inflation, expected money growth from an unsustainable fiscal deficit is signalling a rise in inflation expectations. In so far as near-term inflation is driven by a combination of lagged monetary shocks and expected future money growth, the uptick in bond market rates is a cause to be cautious. A second point is that the long rates are a combination of expected short rates as in the expectations theory of the yield curve and inflation expectations. If as Andrew Lilico has alluded, that the markets are forecasting the Bank's interest rate setting behaviour and the Bank has got it wrong in not reducing rates fast enough, then that error has fed into expectations of short rates. He said that he was also unconfident in the OECD and IMF forecasts of growth in 2025. He said that the economy does not feel as if it is in a 'growth spurt'. He said that he read a recent report about Greggs the fast-food bakers being the new bell weather of the state of consumer sentiment. Greggs have seen a 16% drop in share price, and it may be because they have over-expanded but that simply means consumer demand from cost conscious customers has fallen back. He said that he thought that the economy is much softer than what the OECD and IMF think. He said that like John Greenwood that QT should be suspended to aid the modest rise in money supply growth but at the same time if long term productivity growth is in the region of 1 per cent, a 2 percent inflation target warrants money growth at the lower end of the suggested range of 4-5 per cent.

### **Comment by Philip Booth (in absentia)**

**(St Marys University)**

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

**Bias: No bias. No view on QT.**

Although long-term real interest rates have risen sharply in recent days, a bank base rate of over 2% more than inflation is higher than is necessary given that inflation is relatively close to target. Just as the Bank of England was dramatically behind the curve when adjusting to the monetary conditions of the early 2020s, it risks, once again, being behind the curve. Although the brief analysis of monetary conditions in the last Bank of England Monetary Policy Report was welcome, in its decision-making process, the Bank of England Monetary Policy Committee only takes account of "real" factors and indicators that tend to lag inflation. The result, in terms of the poor record of inflation being close to target, is therefore not a surprise.

### **Comment by Julian Jessop (in absentia)**

**(Independent Economist)**

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

**Bias: To cut further**

Julian Jessop said that he votes for an immediate half point cut in Bank rate with a bias towards further easing, and a pause in QT. Monetary policy remains far tighter than necessary to continue bearing down on inflation, especially with demand now much weaker than expected and the labour market cooling rapidly. Indeed, the much bigger risk for the medium term is that inflation will undershoot the 2% target, given the weakness of money growth over the last two years.

### **Comment by Patrick Minford (in absentia)**

**Business School, Cardiff University)**

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

**Bias: interest rates to fall further.**

Given the sharp decline in money supply growth, it is time that conditions are loosened to allow the economy to recover and money supply growth to stabilise, as inflation gradually reaches its new low equilibrium close to the target. As part of that loosening QT should be paused to signal that long rates are too high. My bias is for rates to fall further.

### **Comment by Tim Congdon (in absentia)**

**(Institute of International Monetary Research, University of Buckingham)**

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

**Bias: Bias to ease.**

Broad money growth has been low/moderate in the recent past, with M4x up by 3.5% in the year to November. The prospect - at current interest rates - is for continued money growth at the same sort of number. Meanwhile the overhang of excess money from the quantitative-easing operations of 2020 and 2021 - which was responsible for the inflation surge of late 2021 and 2022 - has been absorbed. Weak aggregate demand therefore justifies an interest rate cut. However, worries about the damage to the supply-side capacity from the government's tax increases, and the continuation of the woke and green agendas which have blighted UK growth for over 15 years now, argue against radical policy easing. The interaction between financial confidence and the government's debt interest costs also argues for caution in policy moves..

### **Any other business**

There was no other business, and the Chairman called the meeting to a close.

### **Policy response**

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.
3. Three members voted for a cut in Bank rate by 25bps
4. Opinions varied on the future of QT. Six members voted to pause or stop QT. Two members voted to continue with QT, and one had no opinion.
5. Five members of the nine members had a bias to cut interest rates further

### **Date of next meeting**

15 April 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).