Minutes of the meeting of 10 January 2023 (Online)

Attendance: John Greenwood, Julian Jessop, Graeme Leach**,** Andrew Lilico (Chair), Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams.

Apologies: Tim Congdon

Chairman's comments: Andrew Lilico welcomed the committee to the online meeting and invited Peter Warburton to provide his analysis and Kent Matthews to take the Minutes.

International Outlook

Advanced economies decelerating but positive offset from China opening

Peter Warburton said that he finds the world a perplexing place and that there is a wide-ranging set of potential outcomes for the next 12-18 months. He said that he had no strong degree of confidence on any of the outcomes he sees as possible. The initial view about 2022 was that the world economy would rebound vigorously from the Covid restrictions. That was not what happened, and the Ukraine invasion was partly the reason for that. As we enter 2023, we see economic activity decelerating into declines for most advanced economies. There are hopes that a reopening of China will create an offset that supports growth in the world economy. Other Asian economies are expected to show growth. But inverted yield curves, except in Japan, reflect a year of concerted rising short-term rates and gives credibility to the prospect of a recession.

Unrecycled global imbalances are a source of financial instability

The rise in energy prices have created global imbalances between net exporters and net importers of natural resources, but unlike in the past, there is little re-cycling of the surpluses which is a source of financial instability. These surpluses are being used to fund infrastructure projects and other uses but not flowing back as forex reserves into US Treasuries as they used to.

Global debt and central banks forced into monetisation

The consensus of forecasts is for a little growth in the world economy driven by faster growth in the Far East and for inflation to ease back. Short-term rates have risen in anticipation of monetary tightening and bond volatility has risen while liquidity has fallen. Bond markets are serene, and this reflects the expectation that central banks will be cutting rates by the end of the year. Central banks own nearly a quarter of the sovereign debt of the advanced economies which highlights the potential for Central Banks to hold more sovereign debt. But total global debt has reached an all-time high of $300 trillion in 2021 and central banks are being forced into monetisation. He said that it was worth noting that in 2020-2022 the biggest contribution to global debt comes from the US and China.

Debt service costs expected to double in the next four years

Peter Warburton said that the loss of financial discipline during the pandemic has led to a dramatic increase in the debt service burden. Governments cannot allow central banks to undertake unconstrained anti-inflationary policies because of the painful consequences on the economy but spending more on social protection lets inflation take hold. This is the tension in 2023. The rise in public sector debt service is a lose-lose situation. It obstructs attempts to tame the budget deficit and squeezes out programme spending. Debt service costs are expected to double in the next four years.

Weak supply response to price rises

On inflation, he said that there was a strong consensus that it would fall in 2023 which is worrying as he said that he sees energy and food prices as wild cards with the potential to disrupt. However, there is much less consensus about falling interest rates by fund managers. He said that he continued to be concerned about the supply side. The argument for persistent inflation is founded on the lack of political resolve to support central bank anti-inflation policies, and the lack of supply response to higher prices.

Financial risk perceptions worsen

Peter Warburton said that he continued to be concerned about the potential for financial instability particularly in the context of illiquid bond markets. One of the other impediments for governments to resist central bank anti-inflation policy is the potential for financial instability which calls for supportive intervention and interest rates moving downwards. Indicators that credit markets are tightening have worsened and although not as severe as in 2020, they are moving in that direction. Fund manager risk perception have worsened with geopolitical risks adding to the mix.

Restoration of the Fed 'put'….inflation persistence.

There are several reasons why the Fed may flinch from tightening in the coming year - from political pressure to losses in the in the S&P 500, and fear of being blamed for triggering a financial crisis. In the face of tightening credit conditions, the Fed may feel compelled to loosen rates and halt its programme of QT. In this situation inflation emerges as a free variable. He said that his predictions were that the Fed 'put' will be restored once the S&P loses 30-40% off its highs. Fiscal stance will be relaxed. Credit spreads will widen appreciably, debt delinquency, and defaults will rise, and US 10-year yields will peak at 5% in 2024-25.

To summarise the international context, he said that geopolitics trumps national politics, and national politics trumps economic policy. The shifting geopolitical scene and the polarisation of national politics means that the government budget will be the main instrument of economic policy and central banks will be politically constrained.

UK economic and financial outlook

Fiscal policy under pressure,,, Bank may restart QE

Peter Warburton said that his thesis is that the UK economy has been twisted out of shape by the pandemic and the policy responses. Negative supply shocks requires a commensurate reduction in aggregate demand to stabilise inflation. While the Autumn Statement has taken a tighter fiscal stance, the government budget is not under good control with public sector pay pressures underway. The Bank may well need to restart QE to stabilise bond yields.

The UK enters 2023 with a negative momentum with the Bank projecting a prolonged period of contraction with a recovery in the second half of 2024. The inflation projection is reflecting more the model properties of mean reversion to a 2 percent inflation rate rather than the political economy of the inflation process. He said that this was an unreliable projection of the inflation outlook.

Credit conditions will tighten irrespective of the MPC's decision on Bank rate

He said that a decomposition of the recent movement in long-term rates reflect partially the global trend but there is a larger UK premium that arises from the bond market instability of the Truss-Kwarteng experiment. The UK is dealing with a potential higher cost of credit than its competitors. Credit conditions will continue to tighten irrespective of the MPC rate decision. The Deloitte survey of CFOs indicate a rising cost of credit and declining availability of credit. On the mortgage front, over 2 million mortgages are coming to the end of their fixed rate term with resetting of as much as 100 basis points. Broad money and credit have declined sharply but in real terms this is a sharp contraction in the real stock of money.

To summarise the UK situation, Peter Warburton said that the outlook is very uncertain. He said that the consensus for a prolonged but mild contraction underestimates the degree of dowturn the advanced economies will experience in 2023. He said that his inclination is to advise the abandonment of QT and hold interest rates on the basis that credit conditions are tightening on its own accord in 2023.

Discussion

Andrew Lilico thanked Peter Warburton for his presentation and invited comment. He began by making the point that the EU has reduced its energy demand by 20 percent and the UK by 13 percent. Also that the Bank's projection of inflation falling back towards 2 percent was interpreted by the market that interest rate expectations are too high.

Decline in globalisation gives labour greater economic power...wage-price spiral

Julian Jessop said that he met a number of analysts in recent days who are talking about headline inflation falling even further in concert with developments in the commodities market and potential fall in house prices along with the consequences of that. He said that there was concern that core inflation would remain high which would be a problem for central banks. He said that the committee should discuss the potential of a wage-price spiral that keeps inflation higher for longer. There is also the view that some of the disinflationary forces of the past such as globalisation are unravelling adding to global inflation pressure as labour has more economic power adding to wage pressure.

Wage-price spiral unlikely as forward-looking agents react to falling inflation

Patrick Minford said that he was impressed with Peter's comments. His takeaway was that there was a lot more tightness and potential instability in the economy. He said that he agreed with that assessment, and an examination of the money supply figures show that they have fallen very fast. This underlines the point about tightness. Central banks will have to ease off. He said that he agreed with Julian Jessop that commodity prices are sliding because of the fall in demand and supply bottlenecks are easing. Putting all these together, central banks will face not just political pressure but an economic imperative that will drive them to ease rates and rest on their laurels. Regarding the labour market, he said that as inflation eases the pressures on wages will decline as people are forward looking. He said that there is a need for a levelling off of interest rates. He said that there may be a need for QE if markets expect interest rates to rise in the long end. He said that he would like to see a levelling of interest rates with a bias to lowering and the possibility of QE.

Structural issues of an ageing population

Trevor Williams said that he agreed that a wage-price spiral does not stand up to intellectual scrutiny. Firms will pay what their productivity will allow them to pay, or they will go bust. He said that the structural issue is the ageing population. This results in a labour shortage. Firms that can afford to pay higher wages will pay, and others who cannot either lay off staff to pay those they can afford to keep or go bust. The US is exporting lower prices which is a good thing as it means inflation comes down more quickly. He said that consequently there is an upside for growth. While individual countries are expected to show negative growth the consensus forecasts do not have the US or the EU in recession.

Indicators of prolonged working from home expectations

Andrew Lilico commented on the difference in the thinking between Peter Warburton who says that underlying inflation pressure remains high, but Patrick Minford believes that inflation will fall off. He said that he was thinking about the structural changes brought about by covid that might have triggered different working arrangements. Suppose you were pessimistic about the productivity of working from home. He said that one indicator of the increase in the work-from-home trend is the statistics on pet purchase. He said that in 2019 there were roughly 9 million dogs in the UK but in 2022 there about 13 million. This may be an indicator of the proportion of the working population who anticipate that they will be working from home for some time in the future.

China reopening and boost to world economy

Trevor Williams said that the reopening of China will give a boost to the world. If there is also a shrinkage in the money supply in the world's liquidity provider - the US - but it allows people to buy $ assets, the stocks will shrink, prices will rise and yields will fall. This has the effect of exporting deflation to the rest of the world. Policy rates will have to be cut sharply to avoid a too fast decline in inflation.

Graeme Leach said that he agreed with Peter that there were several plausible scenarios. At the previous meeting he said that the seeds of the current slowdown were seen in the rapid decline in broad money growth, with a real threat of a policy overkill by the Bank of England. He asserted that there were considerable opposing forces. On the one hand the sharp slowdown in broad money growth. On the other were supply-side rigidities which were making prices sticky downwards. He thought that on balance, the monetary slowdown was so deep, especially in real terms, that inflation would fall more quickly than markets expect.

Rapid money growth followed by rapid monetary contraction creates the confusing picture

John Greenwood said that Peter Warburton started with the statement that he was perplexed by the state of the global economy. He said that this was the outcome of the reversal in money growth trends in the USA and UK. He said that that on the one hand there was aggressive monetary growth through 2020-21 but in 2022 both in the UK and the US, monetary growth has slowed abruptly. In some respects, the monetary expansion in 2020-21 is still showing up notably in the labour market which tends to be lagging. Of course, there are supply issues with the disappearance of the older workers. But on the other hand, we see the effects coming through of the slowdown in money growth in 2022. So, all the sensitive prices such as commodities, freight rates, and money-market indicators are reflecting this. He said that in six months' time the downturn in money growth will come through in the figures showing up in a softening of the labour market.

UK retirement trends well above OECD average for the same age group

Kent Matthews said that he wondered if the supply-side issue from the lost older workforce will turn out to be as bad as people expect. He said that he was aware of many professionals thinking about taking part-time work partly because they think they have retired too early and are healthy and available for work and partly because of the imperative caused by the rise in the cost of living. Graeme Leach said that he reinforces Kent's statement because he has been doing some work on labour market participation rates. He said that the retirement of the 65+ population, it is well above the OECD average. He said that we don't really have a labour market shortage if the over 65s work a little longer. There are many incentives for the over 65s to return to work.

Trevor Williams said that an examination of the pensions and the inequality index, shows that pensioners have done very well in the last few decades of rising pensions (eg triple lock) and rising house prices and the incentives for them to go back to work are low. One part of this is that the pandemic prompted people to change their lifestyle and where they could take retirement they did. Another part is the long-term sickness issue. It may be long-Covid or a symptom of the NHS's malaise. However, unemployment matches the vacancy rate. This is a clear indication of the mismatch of skills. Some of the older retirees may be able to fill the vacancies but not all, but many have no desire to. He said that there are not the skill sets to match the numbers.

Votes.

Votes are recorded in the order they were given

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To hold Bank Rate. Bias to resume QE.
Bias: Bias to no further rises.

Patrick Minford indicated his vote before he left the meeting at 6pm

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To hold Bank Rate. Abandon QT
Bias: No bias.

Peter Warburton said that in the previous two meetings he had opted for a modest rise in rates but this time he thought that there should be a hold and he is in the wait-and-see camp. The crisis in the pensions industry compounded with other factors created a fragility in the savings industry. He said that until the saving industry can be stabilised, he was not in favour of a resumption of QT. Regarding labour market tightness he said that the UK had an unusually large proportion of self-employed workers and the pandemic saw a tenth lose their businesses. The route back to the labour market for them is not straightforward.

Comment by John Greenwood

(International Monetary Monitor)
Vote: Maintain Bank Rate and abandon plans to shrink the Bank of England's balance sheet for the time being.
Bias: No bias.

John Greenwood said that he also thought that the economy was going to slow down faster than the consensus view. There should be a dial back on the tightening. QT will act as the reverse to QE. The Bank thinks that QT and QE operate asymmetrically. The experience of the US on the use of QT in September 2019 resulting in the credit crunch in the repo market showed that the Bank is wrong. He said that the Bank should review and reduce the targets to reduce the Bank's balance sheet. Reducing the Bank's balance sheet by £80 billion is currently too dangerous.

Comment by Julian Jessop

(Independent Economist)
Vote: Immediate rise in Bank Rate by 50 bps. Continue with QT in 2023 and then pause.
Bias: Neutral.

Julian Jessop said that while he had common ground with Peter Warburton and John Greenwood, he was not fully in accord with them on policy. He voted to raise rates by 50 bps and to continue with the current pace of QT. However, this rate increase should be the last one and he would move to a neutral bias on interest rates. He said that the QT programme should be kept under close review with the possibility of pausing it at some point next year. He said the reason why he is voting for a rate rise is because the Bank has a credibility gap. Interest rates should be at about 4% and given the credibility issue the Bank should put interest rates up and signal that this is the last rise for some time. Regarding QT he said that the blurring of the lines between monetary and fiscal policy means that not only credibility of monetary policy needs to be restored but also fiscal credibility. The need for some QT is to signal that central banks are not going to bail-out governments. However, we are close to the end of the tightening cycle. He said that he was positive on growth and that there are signs that the recession risk is starting to fade.

Comment by Graeme Leach

(Macronomics)
Vote: Hold Bank Rate. No QT
Bias: No bias.

Graeme Leach argued that broad money growth was deep in negative territory in real terms and that as a consequence base rate should remain on hold and QT should be paused. To raise base rates further or engage in QT would risk a double-digit contraction in real

Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: To raise by 25 bps. Continue with Quantitative Tightening.
Bias: No bias.

Trevor Williams said that he agrees with those who argue for the stop point. Business investment as a share of GDP is falling. The supply side has been damaged and at the same time there is a lack of public or private investment to improve the capital stock. Productivity is weak and hours worked has fallen. On top of this we have labour shortages. If QT is expected to reduce the Bank's balance sheet by £80 billion, this will not be offset by commercial bank lending, and so M4 will shrink. Hence, the question is when that signals to financial markets that inflation is no longer an issue so that the Bank can start to cut interest rates in 2024? He said that 3.75% may be too much but that the Bank should do it to crush inflation expectations. He said that rates should rise by 25 bps but signal that the Bank has done enough on rates for now and will wait and see what happens to growth and inflation in H2 – standing to ready to raise rates further if necessary - but to continue with QT.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Hold Bank rate. To hold QT.
Bias: No Bias.

Kent Matthews said that he also was impressed by Peter Warburton's argument that there was more risk in the economy and credit conditions are tightening because of the increased risk. He thought that it was interesting that Peter Warburton and Patrick Minford came to the same policy conclusion from quite opposite reasoning. Peter Warburton wants a hold because he believes that underlying inflation will remain high, but the pain of squeezing inflation will face political economy constraints whereas Patrick wants a hold because forward expectation in the labour market will allow the Bank to hold and then lower interest rates to smooth the coming downturn in the economy. Kent Matthews said that while he was more sanguine about the supply side and the labour shortage, he recognised the widespread expectation that the economy will shrink. It maybe that Julian Jessop is right, and the recession may be mild and not as prolonged as official forecasts have it. It maybe that inflation will fall as Patrick Minford argues or that core inflation will remain high for longer as Peter Warburton has argued. Whatever happens the Bank has been raising rates consistently and it is time to pause and take stock. He said that he was not saying that this is end of the monetary tightening cycle. It may be that interest rates need to rise further if inflation looks to persist for longer. So, he votes for a hold in Bank rate and to hold QT. But the pause is a wait-and-see holding operation and not signal that rates have peaked. He said that it is too early to talk about QE.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate by 25 bps. Signal that QT is the medium-term objective.
Bias: To raise rates.

Andrew Lilico said that the economy faces quite a lot of head winds. One thing that was not mentioned is that there are some tax rises coming in April and the withdrawal of the energy package. There will be big rises in mortgage rates as the fixed rates packages mature. Lower monetary growth will spill over into lower nominal income growth and lower real growth. On the other side we might see a reversal in energy prices and as Trevor Williams has rightly pointed out, the re-entry of China could be significant. He said that although there is quite a lot of downward pressure, we should not think that things are so unstable that we cannot do anything. He said that we should validate some of the expectations of interest rate rises a little. He said that he would vote for a ¼% rise in rates with no bias to raise further. Regarding QT he said that he'd still like to see more of it, but we have not developed our own regulations in controlling state aid the LDI situation would imply a pause in QT for the time being.

Comment by Jamie Dannhauser (in absentia).

Ruffer LLP
Vote: Raise Bank rate by 50 bps. Continue with QT at its current pace.
Bias: To tighten

Any other business

Julian Jessop said that the press release should reflect the change in sentiment of the committee, who are mostly of a Monetarist persuasion, that 6 months ago the monetary conditions indicated a tightening but now it is the reverse.

Policy response

1. The majority of the SMPC voted to hold Bank rate at 3.5%
2. Two members voted to raise Bank rate by 25 bps to 3.75%
3. Two members voted to raise Bank rate by 50 bps to 4 per cent
4. The majority view was that the interest cycle was at or near its peak
5. There was no consensus on the future of QT. Three members felt that QT should be abandoned or paused with one expressing a need for the resumption of QE. Three members voted to continue with QT in 2023

Date of next meeting

11 April 2023.

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, St Mary's University). Other members of the Committee include: Philip Booth (St Mary's University, Twickenham, University of Buckingham), 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 (Institute of International Monetary Research and University of Buckingham).