Minutes of the meeting of 12 July 2022 (Face-to-Face and Online, Ruffer LLP)

Attendance: Philip Booth (online), Roger Bootle, Juan Castaneda (online), Tim Congdon, Jamie Dannhauser, John Greenwood, Julian Jessop (online), Andrew Lilico (Chair), Kent Matthews (Secretary), Patrick Minford, Peter Warburton, Trevor Williams.

Apologies: None received

Chairman's comments: Andrew Lilico welcomed the committee to the second meeting of the year and thanked Jamie Dannhauser for hosting it at Ruffer LLP. He invited Jamie to make his presentation.

Global overview

Jamie Dannhauser began by outlining the theme of his presentation. The prospects for the UK monetary policy followed from the state of the economy, the global backdrop, the financial and monetary conditions, the context of the Covid and Ukraine shocks, whether there is a return to the 1970s, and whether the Fed or the Bank is right about the current economic situation. Jamie Dannhauser said that the long period of disinflation was over before Brexit with the trend in durables goods price inflation moving up before the GFC. Other factors that predated the current supply side issues, relate to the credit cycle and the post-GFC bank regulation raising capital ratios, and liquidity ratios that created deflationary pressures.

Pre-Covid/Ukraine world different than what it was a few decades earlier

An argument that has often been made is that the current global surge in inflation is to do with transitory factors relating to commodity prices and capital goods prices that are mean reverting. He said that he was not convinced by these arguments pointing to the surge in German capital good price inflation and capacity constraints caused by delays in global container shipping. Added to this are supply shocks to fuel and food. However, looking at the real cost of borrowing, he said that although having risen recently it is hard to say that borrowing costs are particularly elevated. He said that while Covid and Ukraine issues are relevant, the world pre-Covid and Ukraine was materially different than what it was several decades earlier. He presented these observations as the global backdrop to the UK inflation outlook.

UK inflation developments and outlook

Core inflation 6-7 per cent and broad based

Jamie Dannhauser presented the Bank of England fan chart of inflation forecasts which showed the serially correlated forecast errors of inflation. The view of the MPC is that the peak will be greater than 11 per cent in Q4 but that the squeeze on real disposable incomes will dampen demand sufficiently to counter a prolonged rise in inflation. They believe that the risks to inflation, three to four years in the future are skewed to the downside. So the question for him is would the disinflationary impact of inflation on demand be big enough to outweigh a durable impact from wages over time. He said that an argument that has consistently come out of the MPC is that inflation is driven by external cost shocks, due to Brexit, Covid, and Ukraine. He questioned this view and argued that the inflation in high intensity import products tells a story of retailers exercising market power to restore margins and is therefore a more domestic generated story rather than an imported price story. However, core inflation is running at above 6-7 per cent and it is broad based, challenging the argument that this is caused by one-off relative price shocks.

Rise in inflation expectations but no evidence of wage-price spiral

On pay, the observation Jamie Dannhauser made is that pay growth is up and not consistent with a 2 per cent inflation target but the data does not show an

obvious price-wage spiral as yet. Available data on household inflation expectations show a rise in recent months. UK company output price expectations data show that firms see no obstacle to raising prices in the next four quarters. Data on housing rental inflation suggest a coming surge and private sector capacity pressure is increasing.

UK real economy and labour market

Rise in job-switching adding to pay pressure

Turning to the real economy Jamie Dannhauser said that the ONS best guess of private sector activity shows that it is well below its pre-Covid level and 8 per cent below its trend. Whereas nominal spending of the private sector is above trend. A measure of underemployment taken as unemployed adults plus inactive adults who want a job plus part-time workers that cannot find full-time jobs, is exceptionally low. Also vacancies as a % of potentially available labour has risen sharply and is hard to square with the lower level of private sector activity. Data on job-switching similar to the US quit rate concept has risen sharply adding to pay pressures. Other labour market pressures are seen in the Covid-induced negative labour supply shock to males aged 50-64 and the locational mismatch in employment reflecting where people are choosing to live and possibly working from home.

Money stock or flow?

Looking ahead, he said that survey data on UK consumer confidence is at its lowest level, but companies are bullish with the net % expecting a rise in activity and staffing rising sharply. He said there is an interesting consumer-business dichotomy in expectations. Jamie Dannhauser said that the money stock is 11 per cent above its pre-Covid trend and real money balances is also excessive compared with trend but is contracting. He said that this raises interesting questions about whether it is the stock of money or the flow that matters given that the growth of the money stock is falling.

Exceptional negative real rates

He said that mortgage competition remains intense although mortgage rates are rising. He said that the spread on high LTV mortgages remains fairly low and the RICS survey of housing shows that while there has been a small downturn in new buyer enquiries, there is no evidence of a housing market slowdown. The news from credit data is mixed but bank funding costs are on the rise. However, the journey the Bank of England is starting from is one of exceptional negative real short-term rates of interest which shows how far they have to travel to normalise monetary policy.

Policy Deliberations

Recession is a price worth paying

Jamie Dannhauser said that the obvious observation is that inflation is very high and that his hunch is that a recession is nearby. The chance of a downturn in the next 6-12 months is elevated. The question is, would the recessionary forces be strong enough to dampen the inflationary forces in the economy? Monetary policy is still accommodative. Both Covid and Brexit have induced large negative supply shocks and sterling weakness remains an issue that would exacerbate the built-in inflationary pressure. Policy is far too loose and that has made the journey for the Bank of England difficult. He said that he puts a high weight on the danger of inflation being ingrained in expectations and wage growth. Jamie Dannhauser said that a recession is a price worth paying for price stability. He said that inflation is skewed to the upside and that he would vote for a rise of 50 bps immediately and signal similar rises in the months ahead. He would also shrink the Bank of England's balance sheet at about £20 bn a month.

Discussion

Andrew Lilico thanked Jamie Dannhauser for his presentation and started the questions by asking if inflation and inflation expectations are rising, why wages are not rising in the face of a tightening labour market. Jamie Dannhauser said that there are lags in the system and that it is going to happen but hasn't happened yet. But it is also an issue of risk management for policy. He said that there is a danger that pay settlements rise at a rate inconsistent with the inflation target and policy needs to address that.

Excess money balances must work its way through the system…

Tim Congdon said that regarding the issue of the money stock, if the ratio of M4 to nominal GDP is taken the excess money is more than 11 per cent. That reflects to some extent the fact that nominal GDP has not caught up as yet with the increase in M4. He said that it is fair to think of the supply side has contracted by about 3 per cent in the last 2 years but there was quite a lot of inflation to come through. The rate of money growth in the UK has fallen back and the rate of growth of money in the USA has fallen back even more. But even with money supply growth falling there is still a large amount of excess money working its way through the system. Peter Warburton said that the terrible balance of payments figures and the healthy profitability figures indicate that there is far too much money in the system. John Greenwood said that for forward looking analysis the issue is how long it will take for the ratio of money supply to GDP to return to trend. The work he has done suggests that this will take as long as 2024-2025. This would entail at least an extra 2 per cent increase in prices each year over the inflation target, implying a price level rise of 4 per cent per annum for the next threee years before equilibrium is restored. Trevor Williams said that the change in the trend in the stock of money depends on the speed at which money supply growth declines and that in turn depends on how quickly QE is unwound.

…. which can take as long as 2024-2025 adding 2% inflation each year

Julian Jessop commented that one reason why wage growth might not be stronger is that workers are prioritising job security instead - as seen also in the large switch from self-employment to payroll employment. Another possible explanation is that real wages are still higher than their pre-pandemic level, so looking only at the latest year-on-year changes could be misleading.

Philip Booth suggested that institutional factors may have caused real wage rigidity in an upward direction. Ten percent of people receive the minimum wage and a significant proportion are linked to the minimum wage. This has created an administrative reference point for employers when times are stable which might be leading to greater wage stickiness when there is a high demand for labour.

Supply shocks unravel

Patrick Minford said that he takes a much less deterministic view of the situation than others. The situation is dominated by expectations of what people think monetary policy will be. He said that the consumer confidence index is unreliable as it typically reflects what the press are saying at the time. He said his view is that there has been a huge supply shock and this will eventually unravel. The central banks fed money into the system and increased QE. The central banks became complacent about QE because the last time they used it in the GFC, it did not have any effect on credit and the money supply because of bank regulation. This time the money supply was affected and that added an extra shock to the original supply shock. The question is how quickly these shocks are going to unravel and the actions the central banks will take. He said that the central banks will react strongly. The psychology of the market will change quickly to a tightening in monetary policy.

Failure to distinguish between relative and absolute prices

John Greenwood said that one of the big problems has been the unwillingness of central bankers and economic commentators to distinguish between absolute and relative prices. He said that it was absurd to say that inflation has gone up because oil prices have risen. He said that Arnold Harberger often said that inflation and growth are like mushrooms: you plant the spores but you don't know where they are going to pop up. Inflation pops up in different prices at different times. But excess money shows up in inflation and worrying about whether it gets into this sector or that sector is irrelevant. The best illustration of

the difference between overall proices and relative prices was the Japanese reaction to the first oil crisis and the lessons the Bank of Japan learned for monetary growth in the second oil crisis. Lower money growth in the second oil crisis meant that relative prices of energy and imported goods rose sharply but (overall) consumer prices rose by much less. In the case of the Bank of England monetary growth is currently about 5 per cent year and it needs to stay there. In the US the Fed is driving money growth down to zero and they will face a serious recession if this continues. The central banks think that raising interest rates now will solve the problem but the inflation we see now is because of what they didfrom March to August or December 2020. He said that like Tim Congdon he shares his view that there is no need to hike rates precipitously.

Failure to distinguish between relative and absolute prices

As some members had to leave early, Andrew Lilico asked members to explain their recommendation.

Votes.

Votes are recorded in the order they were given

Comment by Phillip Booth

(University of Buckingham, St Mary's University)
Vote: To raise Bank Rate by 50 bps. To hold on QT.
Bias: To raise rates

Raising rates will exacerbate the cost of living crisis in the short term

Philip Booth said that as inflation rises, real interest rates fall, and this means that the likely future direction of nominal interest rates should be upwards. Although real interest rates are relevant for monetary policy (where interest rates, rather than direct control of the supply of money, is the preferred lever), it is nominal interest rates that are often important for household budgets. It is therefore understood that raising interest rates will exacerbate the cost-of-living crisis in the short term. However, it is necessary to deal with the longer-term problem of inflation". He voted to raise Base rate by 50 bps and to hold on QT

Comment by Roger Bootle

(Capital Economics)
Vote: Raise Bank Rate by 50bps.
Bias: To tighten.

Recession coming but inflation will fall back

Roger Bootle said that recession is coming but inflation will fall back in the middle of next year and he said that it would be interesting to see how the policy makers react to that. He said that his worry is that inflation will get stuck at 5-6% without further monetary policy intervention. He said that he favoured an immediate 50 bps rise in Bank rate and carry on doing that. He said that he was also worried about the interaction with sterling.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate by 50 bps. To begin QT.
Bias: to raise rates.

Bank signals policy tightening

Patrick Minford said that Bank rate should be raised by 50 bps and QE reversed at the rate of £20 bn a month. The Bank should signal that it is going to pursue such a polcy, then people will treat the inflation rise as a temporary shock and will use their savings. Consequently the recessionary impact will not be as bad as people think.

Comment by Tim Congdon

(Institute of International Monetary Research, University of Buckingham)
Vote: Raise Bank Rate by 50 bps and to control broad money growth
Bias: No bias.

Money growth must be low and stable

Tim Congdon said that this episode is a clear confirmation of the Quantity Theory of Money. Where policy should go is that there should be a low and stable growth of the money supply. The acceleration in money supply in 2020 was due to QE. With its ending and reversal, the rate of growth of money should get back to 3-4% and therefore there is no need for a dramatic rise in Bank rate. It is not clear that we need positive real rates when inflation is 4-5%. It may be correct in the cycle that there should be negative real rates for some time. He said there will be a recession and that he is in favour of raising Base rate by 200 bps over the next 6 months. He said that the most important thing is to have stable money growth starting with a 50 bps rise immediately but to wait and see the effect on the economy.

Comment by John Greenwood

(International Monetary Monitor)
Vote: Raise Bank Rate by 50 bps. Target growth rate of broad money 4-5 per cent.
Bias: No bias.

Money growth 4-5% a year

Banks were faced with all sorts of regulations post-GFC that curtailed their lending. It is not clear how they will react now to higher interest rates. He recommended that the MPC raise Base rate by 50 bps, but money growth needs to be kept 4-5 per cent a year. If money growth falls below this range and heads towards zero, then the Bank will have overdone it. He said he is not overly concerned about the central bank's balance sheet and he is not obsessed with reducing it.

Comment by Julian Jessop

(Independent Economist)
Vote: Immediate rise in Bank Rate by 75 bps.
Bias: To raise rates.

Bank needs to get ahead of the curve

Julian Jessop said the biggest problem is that central banks have lost credibility. Given that interest rates are still far too low, especially in real terms, the question is should they be raised by 50bps or 75bps. Now that people are already talking about a 50bps increase, the Bank needs to get ahead of the curve and raise rates by more. His vote was therefore for a 75bp hike to signal that the MPC is serious about doing 'whatever it takes' to get inflation back down again.

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Comment by Trevor Williams

(University of Derby, St Mary's University, and TW Consultancy)
Vote: Raise Bank Rate by 50 bps possible ¼% rise to 2% thereafter. Start Quantitative Tightening.
Bias: No bias.

Trevor Williams said that the rate of growth of real money balances is declining fast. That should have a substantial impact on inflation expectations. The Bank rate should rise by 50 bps immediately, possibly rising to a Base rate of 2 per cent in the coming months and then pause. The Bank will send a further message to influence expectations by conducting active QT, which will drive down money supply growth to zero or below. The advantage of this policy tool is that it can be quickly switched off. On the real side of the economy, the UK benefits system does not do enough to alleviate in-work poverty, which has resulted from the UK's low productivity since 2007. There is a compositional effect, therefore, in a rise in the share of low-pay jobs relative to high-pay employment. Until this mix changes, he said that the economy would continue with low wage inflation, posing little risk to price.

Comment by Juan Castaneda

(Institute of International Monetary Research, University of Buckingham)
Vote: Raise Bank Rate by 25 bps. To keep the annual rate of growth of broad money stable at around 5%.
Bias: No bias

Danger of money growth falling too fast

Juan Castaneda said that broad monetary growth (as measured by M4x) has been decelerating too fast in recent months. He said he was worried that money growth will fall too sharply and therefore he would not advocate QT. The Base rate should be raised by 25 bps as a signal of Bank of England intention and then there should be a pause to see what happens with monetary growth. But the main policy focus of the Bank should be to maintain the annual rate of broad money at a 4% - 5% annual rate, compatible with 2% price stability.

Comment by Peter Warburton

(Economic Perspectives Ltd)
Vote: To raise Bank Rate by 25 bps. No change in QE.
Bias: No bias.

Peter Warburton emphasised the brutal impact of the fiscal adjustment that is taking place here and in the USA. The forces bearing down on the economy are abrupt fiscal adjustment, expectations of tighter monetary policy, the end of debt forbearance where individuals and businesses are having to catchup on financial obligations that were suspended during the pandemic, and the real income squeeze. He said there is both recession risk and financial stability risk in the economy. Financial conditions are tightening much more dramatically than any single measure can show. Hence QT would be a mistake. He said there is a high risk of a fall in financial asset prices and real estate prices. Central banks, including the Bank of England, have missed the boat. The market-led tightening should prove sufficient to deliver a contraction in the real economy, with attendant benefits on the inflation front. While it was clearly appropriate for the Bank to endorse the need for tighter conditions, to embark on 50bp or 75bp

Recession risk and financial stability risk

increases in Bank Rate now would risk overkill. He voted to raise Base rate by 25 bps.

Comment by Andrew Lilico

(Europe Economics)
Vote: To raise Bank Rate by 75 bps. To begin QT.
Bias: To raise rates.

Accommodation follows high excess money balances

Andrew Lilico said that he there will be multiple pressures on household budgets from various sources. But where there are high excess money balances there will tend to be accommodation of inflationary pressures, such as will appear in wage setting. In that context it is important for the credibility of inflation management that policy makers are seen to be doing something. He said that Base rate should be raised by 75 bps as an acknowledgement that the Bank has got behind and that they had to make a statement. He said there is no rush for QT.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)
Vote: To Raise Bank Rate by 50 bps. To begin QT.
Bias: to raise rates.

Market expects rates to rise steadiliy

Kent Matthews said that he was impressed by the argument that the market was already tightening. As he noted at the previous meeting credit conditions had tightened, and a rise in Base rate of 50 bps is in keeping with market expectations. He said that the market tightening is evidence of expectations of further steady rate rises and a precipitous rise would have an undesirable negative monetary shock. The excess money held by households would be used to smooth consumption even as inflation bites into real disposable income. This would soften recessionary pressure and lean against wage pressure. He voted for an immediate rise in Base rate by 50 bps with a bias to further rises gradually and to reverse QE.

Any other business

The Secretary said that as 12 members of the committee attended the meeting. The views and recommendations of all will be recorded but in keeping with convention, the votes of the first nine arriving will be used to make the recommendation of the Committee.

Policy response

1. The SMPC voted unanimously to raise Bank rate immediately
2. There was not unanimity on the scale of the rise in Bank rate
3. Two members voted to raise Bank rate by 75 bps to 2 per cent
4. Six members voted to raise Bank rate by 50 bps to 1.75 per cent.
5. One member voted to raise Bank rate by 25 bps to 1.5 per cent.
6. In keeping with the voting convention, the Committee recommends that Bank rate be raised by 50 bps to 1.75 per cent.
7. There was a majority view that that Bank rate should be raised further over the coming months.
8. Four members expressed caution and indicated no bias in the direction of monetary policy and advocated a pause to evaluate policy impact

Date of next meeting

11 October 2022.

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).