INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Analysis and insight into trends in money and banking, and their impact on the world's leading economies

www.mv-pt.org

Will UK inflation exceed the top of the permitted 1% - 3% range? And, if so, why?

A presentation by Professor Tim Congdon CBE,

Chairman of the Institute of International Monetary Research,

in April 2021

'BofE must end its asset purchases to avoid stoking inflation' *- Letter from ten members of the Shadow Monetary Policy Committee – 20 April, 2021*

20

FINANCIAL TIMES

'Without fear and without favour'

TUESDAY 20 APRIL 2021

★ FIN.

Tuesday 20 April 2021

Letters

Email: letters.editor@ft.com
Include daytime telephone number and full address
Corrections: corrections@ft.com
If you are not satisfied with the FT's response to your complaint, you can appeal to the FT Editorial Complaints Commissioner: complaints.commissioner@ft.com

BoE must end its asset purchases to avoid stoking inflation

We are a group of economists shadowing the Bank of England's monetary policy committee and we write to express our concern about the rapid growth of the quantity of money.

We believe that above-target inflation is to be expected in 2022 and perhaps 2023. In our view, the Bank of England will be to blame for this setback, as it took the measures that have pushed money growth to its current excessive level (Opinion,

money held by genuine non-banks and cuts out the often-distorting influence of quasi-banks or "intermediate other financial corporations". However, the MPC's key decision makers appear to pay insufficient attention to their excellent data. In the year to February, M4x increased by 15.2 per cent, much the highest figure since the start of the M4x series in 1998.

Other money series have been

this have been previously recorded only in the inflationary 1970s and 1980s. The last time an annual growth rate of company money reached 30 per cent was in late 1986, ahead of the boom years of 1987 and 1988.

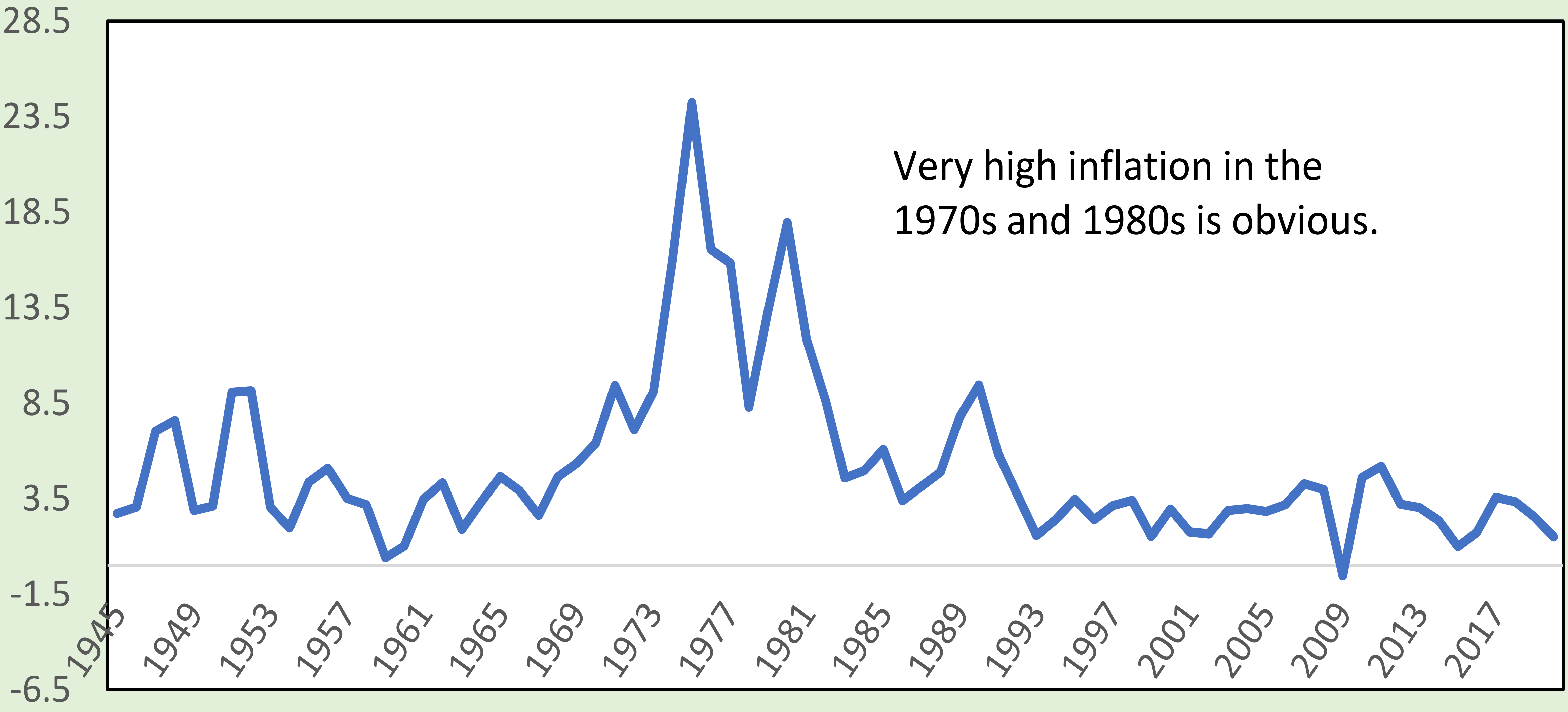
We fear that inflation above 5 per cent is likely at some point in the next few years. We judge that the MPC's decision in November 2020 to embark on another round of quantitative

reconsidered. The BoE should now end its asset purchases at the earliest opportunity.

Professor Tim Congdon
Chair, Institute of International Monetary Research, University of Buckingham
Julian Jessop
IEA Economics Fellow
Andrew Lilico
Europe Economics
Professor Kent Matthews

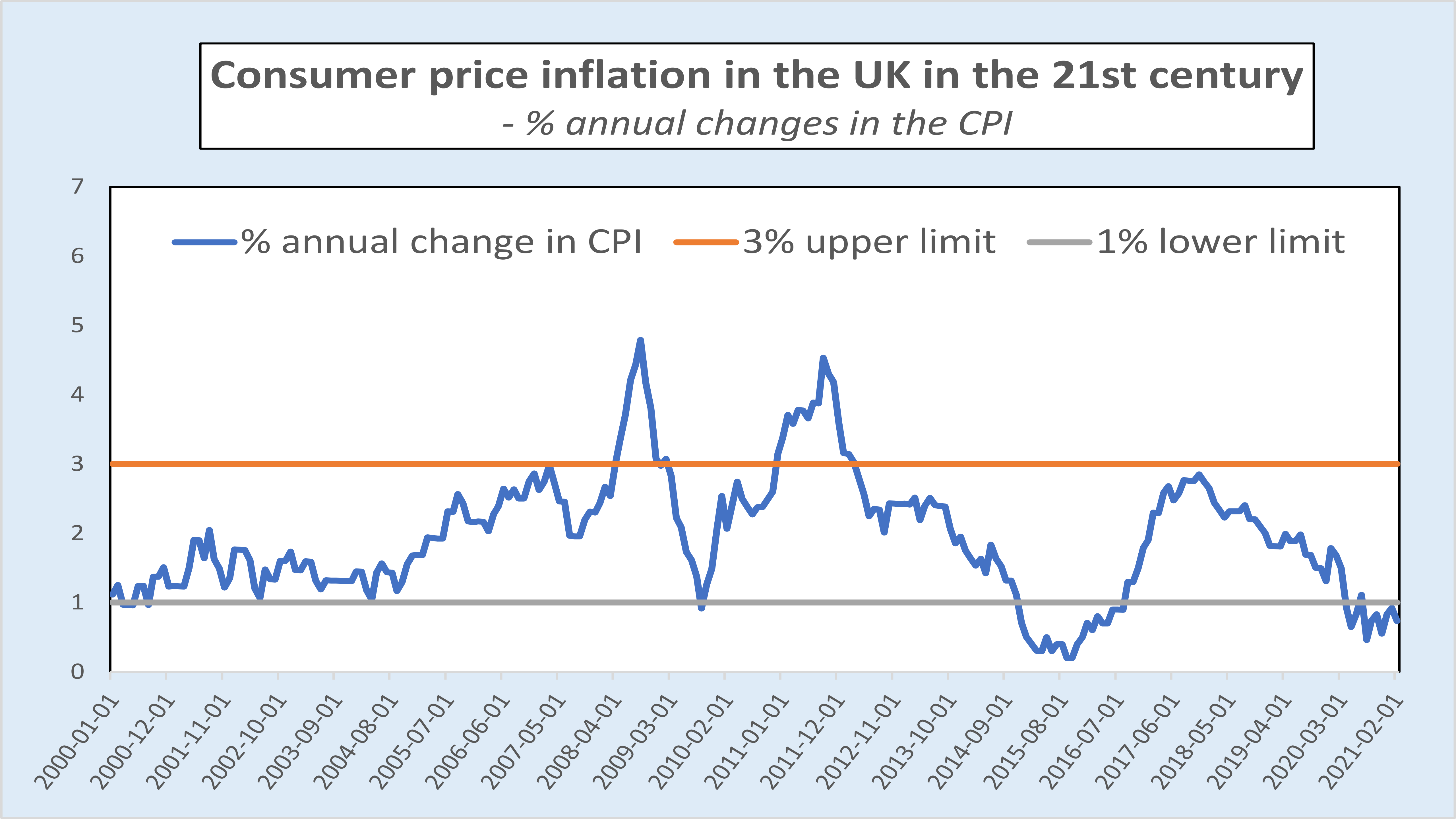
UK inflation since the Second World War

- *Annual % change in the retail price index*



Inflation targeting in the UK

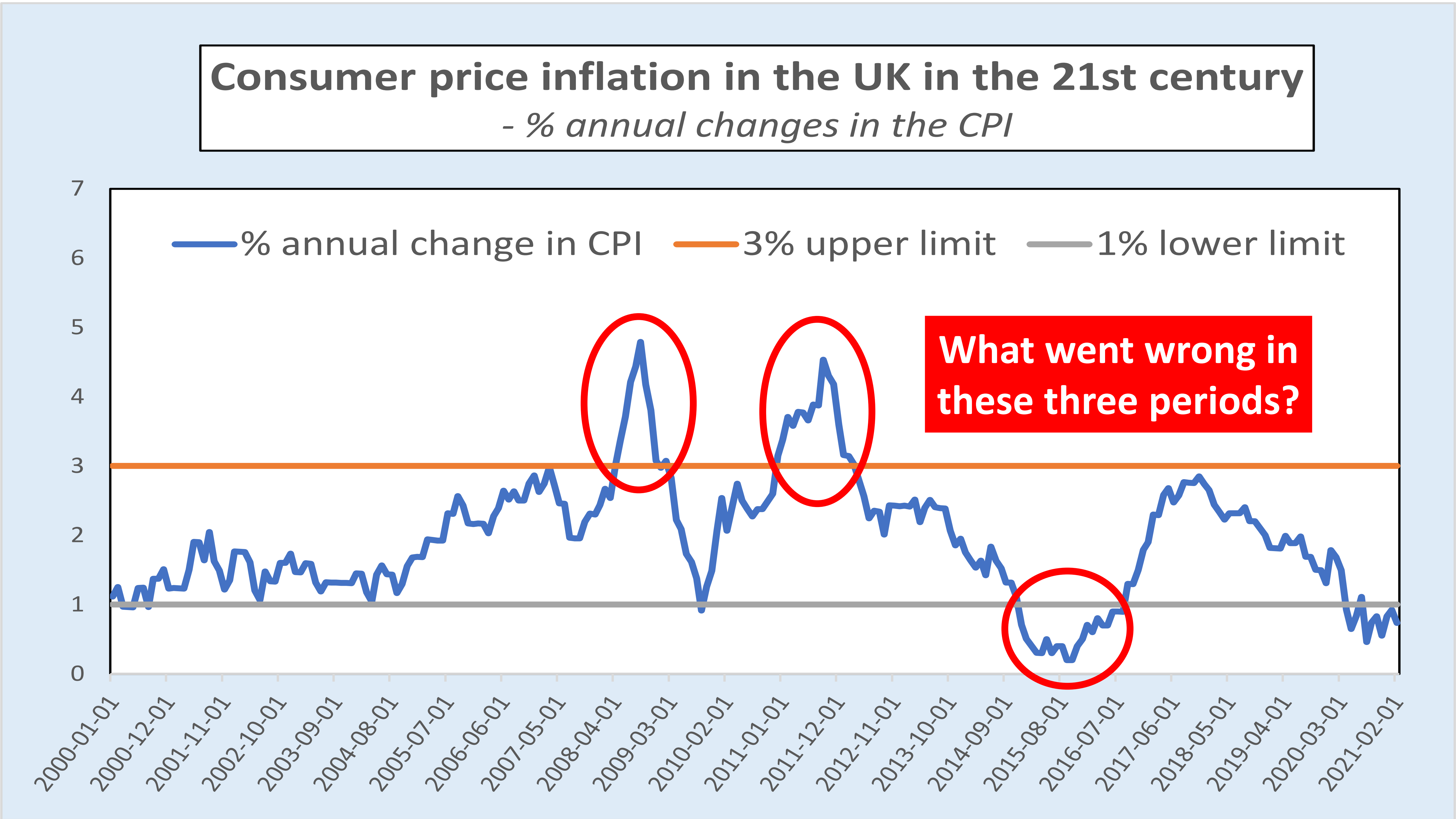
- Inflation targeting was introduced in the UK in October 1992, less than a month after sterling's expulsion from the European exchange rate mechanism on 16 September.
- Initially the target was for **the annual rate of increase in the *retail* price index, exclusive of housing costs, to lie between 1% and 4%**, with the intention that the figure be towards the lower end of this range towards the end of the then Parliament, i.e., the Parliament elected in April 1992.
- But in December 2003 this was changed to **a target for the *consumer* price index, which was to rise by 2% a year and stay within a band of increase between 1% and 3% a year**.



Consumer price inflation in the UK in the 21st century
- % annual changes in the CPI
% annual change in CPI
3% upper limit
1% lower limit
0
1
2
3
4
5
6
7
2000-01-01
2000-12-01
2001-11-01
2002-10-01
2003-09-01
2004-08-01
2005-07-01
2006-06-01
2007-05-01
2008-04-01
2009-03-01
2010-02-01
2011-01-01
2011-12-01
2012-11-01
2013-10-01
2014-09-01
2015-08-01
2016-07-01
2017-06-01
2018-05-01
2019-04-01
2020-03-01
2021-02-01

Inflation targeting in the UK

- But in December 2003 this was changed to **a target for the *consumer* price index, which was to rise by *2% a year* and stay within a band of increase between 1% and 3% a year**.
- The average annual rate of increase in the CPI from January 2004 to February 2021 was in fact ***2.1%***.
- In that sense the target has been met. There is a clear and marked contrast with the 1970s and 1980s, which had a much higher average level of inflation, as well as greater volatility.

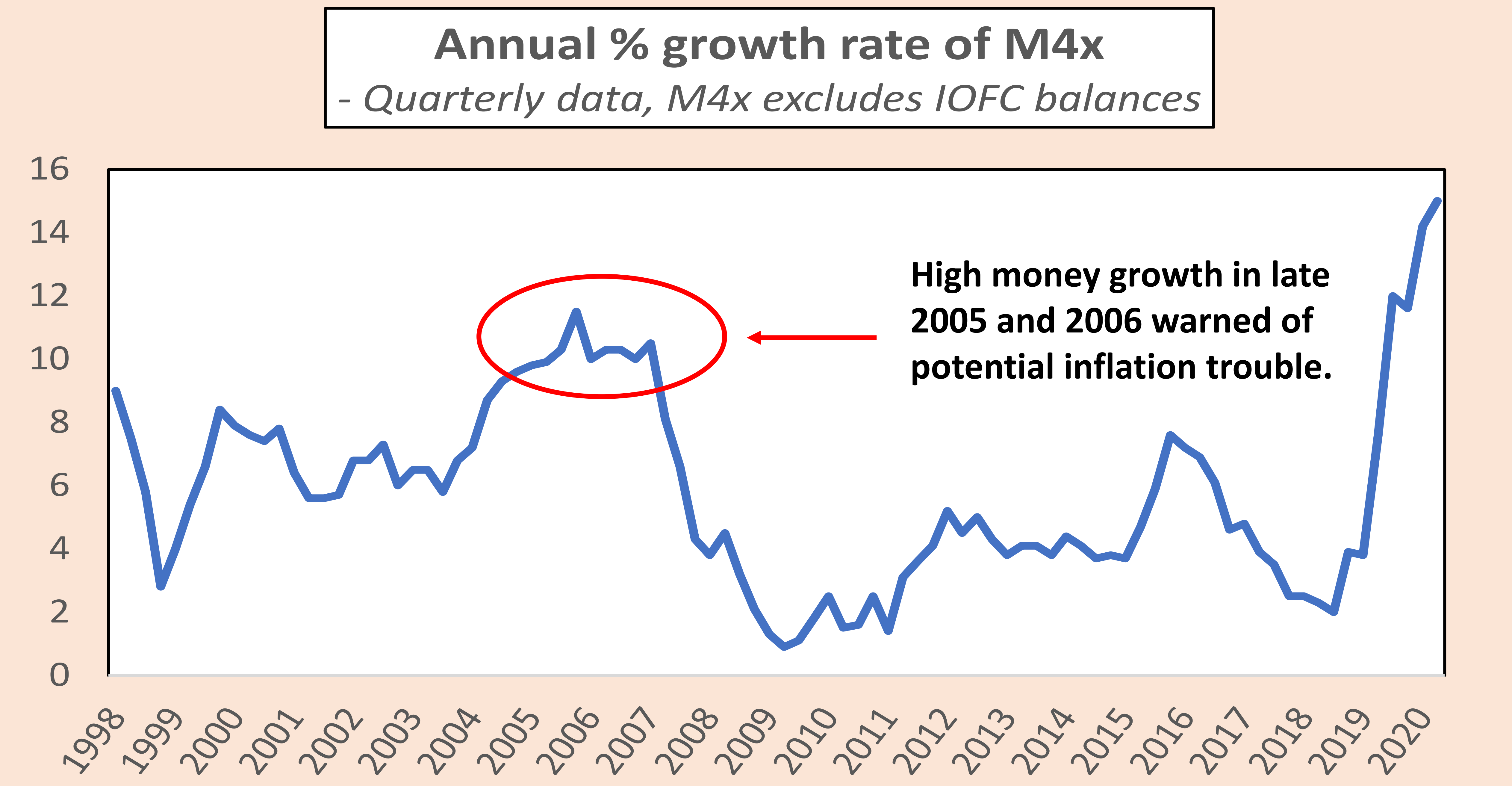


Consumer price inflation in the UK in the 21st century
- % annual changes in the CPI
% annual change in CPI
3% upper limit
1% lower limit
What went wrong in these three periods?
7
6
5
4
3
2
1
0
2000-01-01
2000-12-01
2001-11-01
2002-10-01
2003-09-01
2004-08-01
2005-07-01
2006-06-01
2007-05-01
2008-04-01
2009-03-01
2010-02-01
2011-01-01
2011-12-01
2012-11-01
2013-10-01
2014-09-01
2015-08-01
2016-07-01
2017-06-01
2018-05-01
2019-04-01
2020-03-01
2021-02-01

Money and nominal GDP in the UK, 1964 – 2019

- Money has grown slightly faster than GDP over this period, mostly because financial liberalization has made money more attractive to hold.

	% annual growth rate:	
,	M4/M4x	Nominal GDP
1964 - 2019	**9.6**	**8.0**
1991 – 2000	**6.4**	**6.0**
2001 – 2010	**6.5**	**3.9**
Nine years to 2019	**4.0**	**3.7**


Annual % growth rate of M4x
- Quarterly data, M4x excludes IOFC balances
16
14
12
10
8
6
4
2
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
High money growth in late 2005 and 2006 warned of potential inflation trouble.

I did express concern in late 2006 – and also in evidence to the Treasury and Civil Service Committee of the House of Commons in early 2007 – that money growth was excessive…and might lead to rising inflation.

This was essentially correct – but I did not foresee all the events over the next two years which culminated in the Great Recession.

The blunders of boom and bust

Sunday Telegraph 3/9/06.

Tim Congdon

Economic Agenda

Stability has been the greatest economic blessing of the period since Black – or Golden – Wednesday (September 16 1992) when the pound was expelled from the European exchange rate mechanism. Inflation has been within 1 per cent either side of 2 to 2·5 per cent, demand and output have grown without interruption, and employment has increased from 25·5m to almost 29m. These have been the Nice (non-inflationary, consistently expansionary) years of which the Bank of England – in charge of economic management since 1997 – has rightly been so proud.

The 1970s and 1980s seem a long time ago; for the young, the boom-bust era is barely a memory. The first-time home-buyer in 2006 would be startled to be told that the average mortgage rate in the 1980s was 12 per cent, over double what he or she would regard as a high rate.

But will economic Nice-ness last for ever? Crucial in any assessment of the future is an analysis of the past and, in particular, an explanation of why the boom-bust cycles happened. The subject is difficult and hugely controversial. However, one view – that the boom-bust cycles were caused by wild swings in monetary growth – is backed by a great deal of evidence.

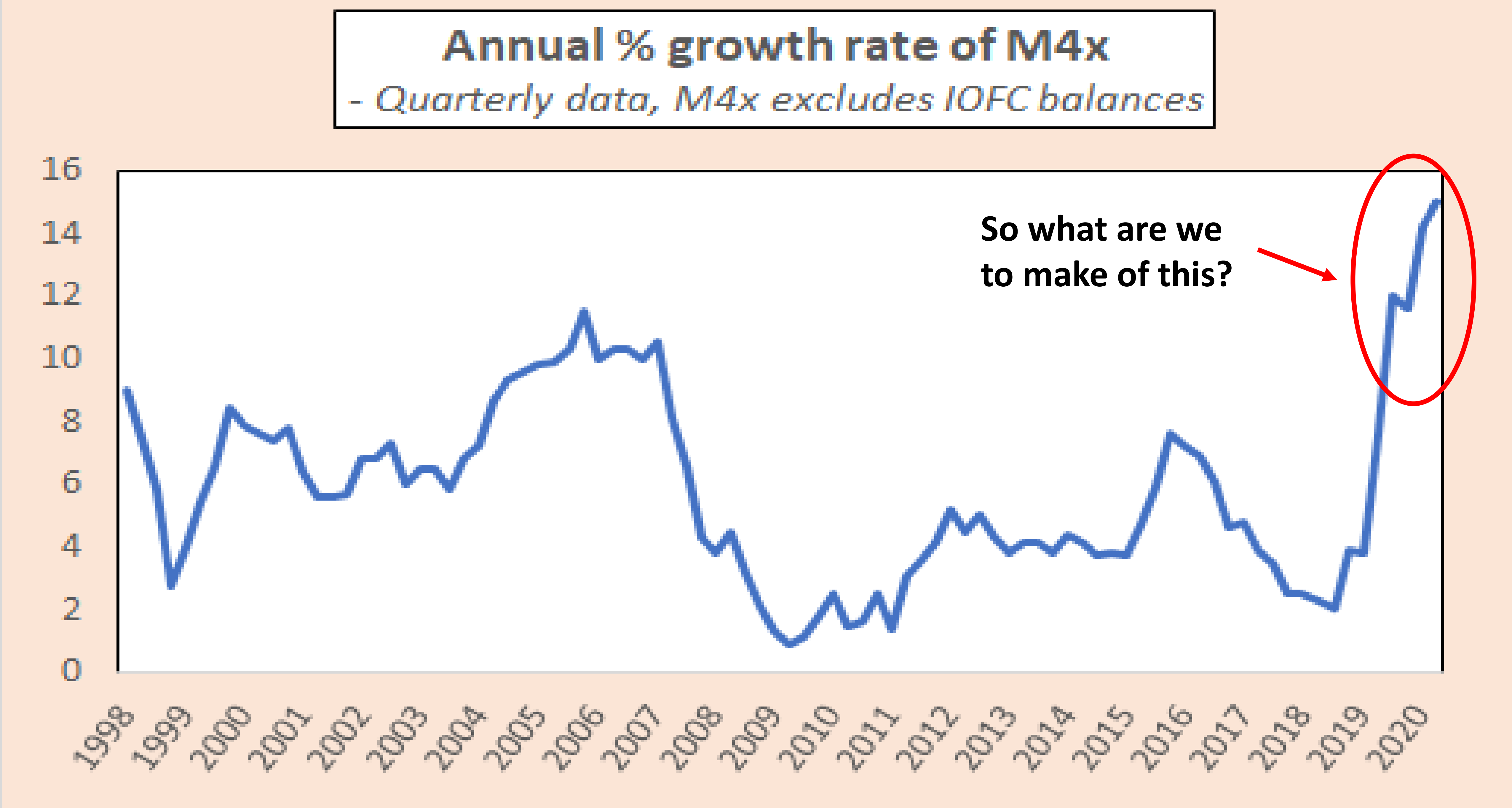
The bad old days

THE typical cycle started with a cut in interest rates or a relaxation of credit restrictions. That encouraged the banks and building societies to lend more, with much of the extra credit financing house purchase. When banks increase their loans, they also expand their deposits. Deposits are money that can be spent an indefinitely large number of times in the future.

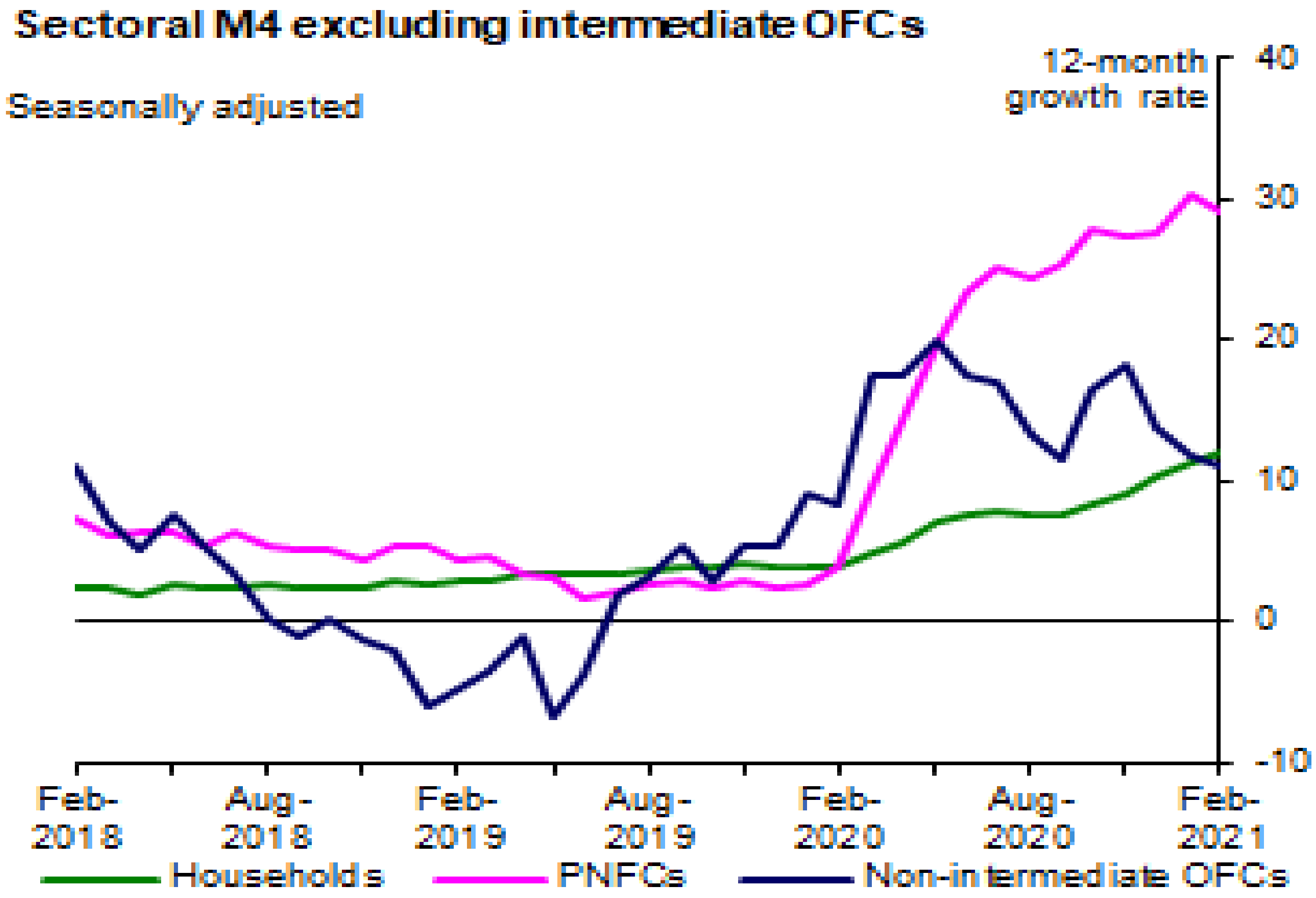
So low interest rates and credit relaxation – as in late 1971, mid 1977 or late 1985 – were followed by rapid growth of bank deposits in 1972, 1978 and 1986. Within the UK, the extra deposits then had to be held by households, companies or financial institutions. It followed that if the money holdings of one of these three groups grew at much the same rate as before, the rise in the growth rate of total bank deposits had to be accompanied by a leap in the growth rate of the deposits held by one or the other of the two groups. In practice, much the same pattern was repeated in all the big fluctuations in the boom-bust era.

The household sector's money balances plodded along at much the same sort of growth rate year after year, roughly in line with personal incomes. Companies' bank balances were more volatile, but were still related to turnover and activity. The result was that quite modest changes in the growth rate of total money translated into enormous swings in the growth rate of money held by the remaining sector, the financial institutions.

Total money (dominated by bank deposits, but with notes and coin tacked on) rose by 20 per cent in 1972, 15 per cent in 1978 and 15 per cent again


Annual % growth rate of M4x
- Quarterly data, M4x excludes IOFC balances
So what are we to make of this?
16
14
12
10
8
6
4
2
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020

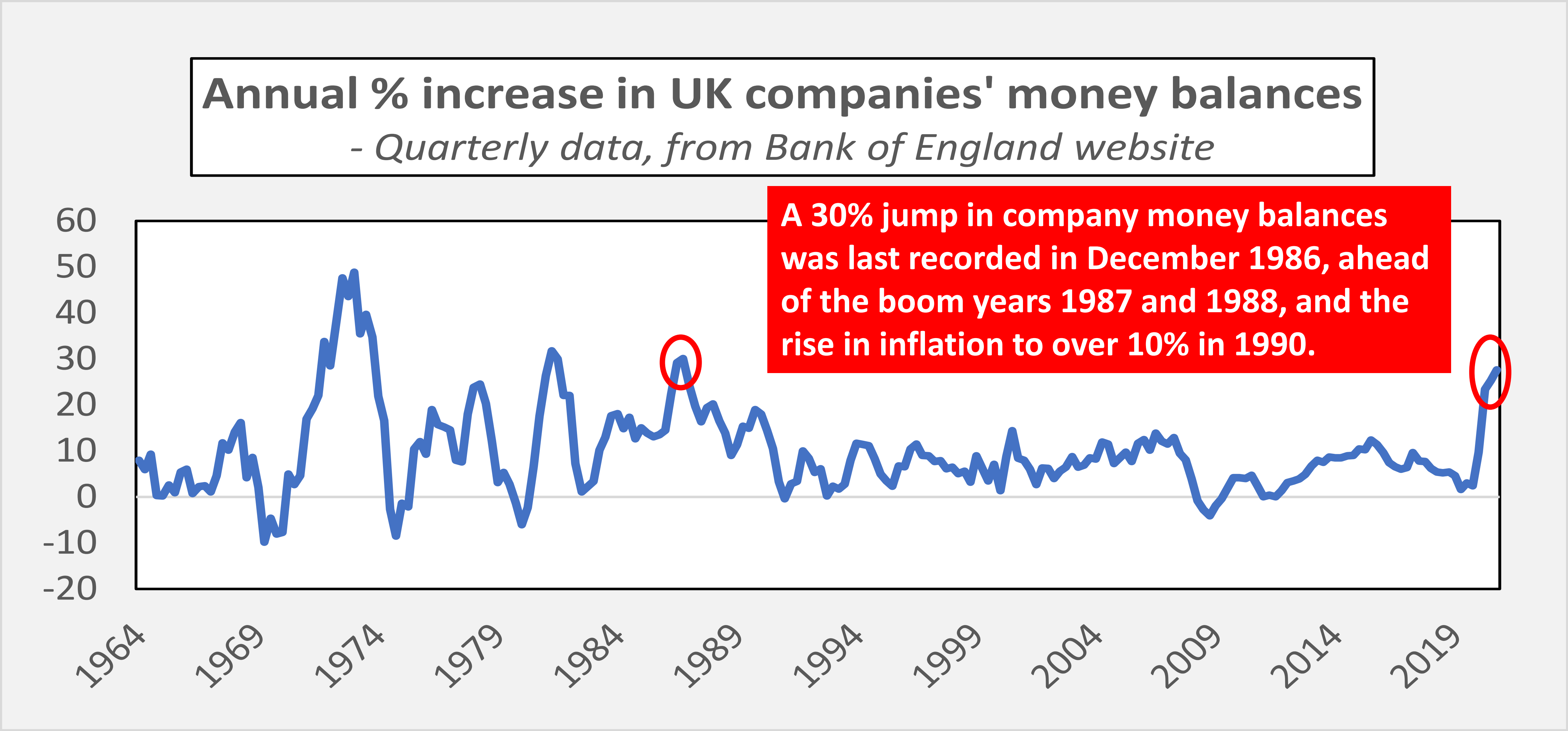
Money growth pattern recalls other booms



Company money holdings have shot up by 30% in the last year. Non-household money growth at explosively high rates is a classic symptom of excess money balances.

Chart is from Bank of England website, to whom many thanks.

Money growth pattern recalls other booms



Professor Tim Congdon CBE: background

- Examples of Congdon’s major calls

1. Beginning in late 1985 Congdon warned that rapid growth of broadly-defined money in the UK would lead to a boom (‘the Lawson boom’), **a rise in inflation and a bust**. On the back of the success of this forecast, he founded Lombard Street Research in 1989.
2. In September 1992 the pound was expelled from the ERM on Black/Golden Wednesday, with many economists forecasting that the pound’s fall would cause higher inflation. **Congdon correctly said in late 1992/early 1993 that it wouldn’t and instead the next few years would see good growth and low inflation.**
3. In late 2008 Congdon advocated ‘quantitative easing’ to counter the emerging Great Recession, and said that it would not lead to either rapid growth of the quantity of money or to a rise in inflation. Contrary to Liam Halligan (who criticised Congdon in *The Sunday Telegraph*) and other economists, **he expected QE to be accompanied in the 2010s by low inflation**.

The current money growth upsurge

1. The annual growth rate has reached **15.2%, quite a bit higher than in the 2005 -06 episode**, when the peak (in Q4 2005) was 11.5%.

2. In the 2005 – 06 episode double-digit annual M4x growth (or almost double-digit annual growth) lasted for almost 2½ years. So far – in the current episode – **annual growth in the double digits has been recorded for only a year**.

3. The trend growth rate of real output in the UK economy is lower now than 15 years ago, because of more adverse demographics.

The current money growth upsurge

1. Very few examples are available, over the historical record, of large changes *over the medium term* in the ratio of money to GDP of more than 3% a year.

2. No one knows exactly how much money growth will be in the rest of 2021, and in 2022 and 2023. Let us assume 7% in the year to December 2021, and 4% in the two following years. In other words, let us assume that money growth reverts to the previous typical number in the years before Covid-19. **Then the average growth rate of money in the five years to end-2023 would be 6.6%.**

3. If we allow 1% a year for trend real growth, 1% a year for a rise in the ratio of money to national income and 1% a year to be on the safe side**, the implied average inflation rate in the 2019 – 23 period is 3½ %.** Inflation was less than that in 2019 and 2020.

The current money growth upsurge

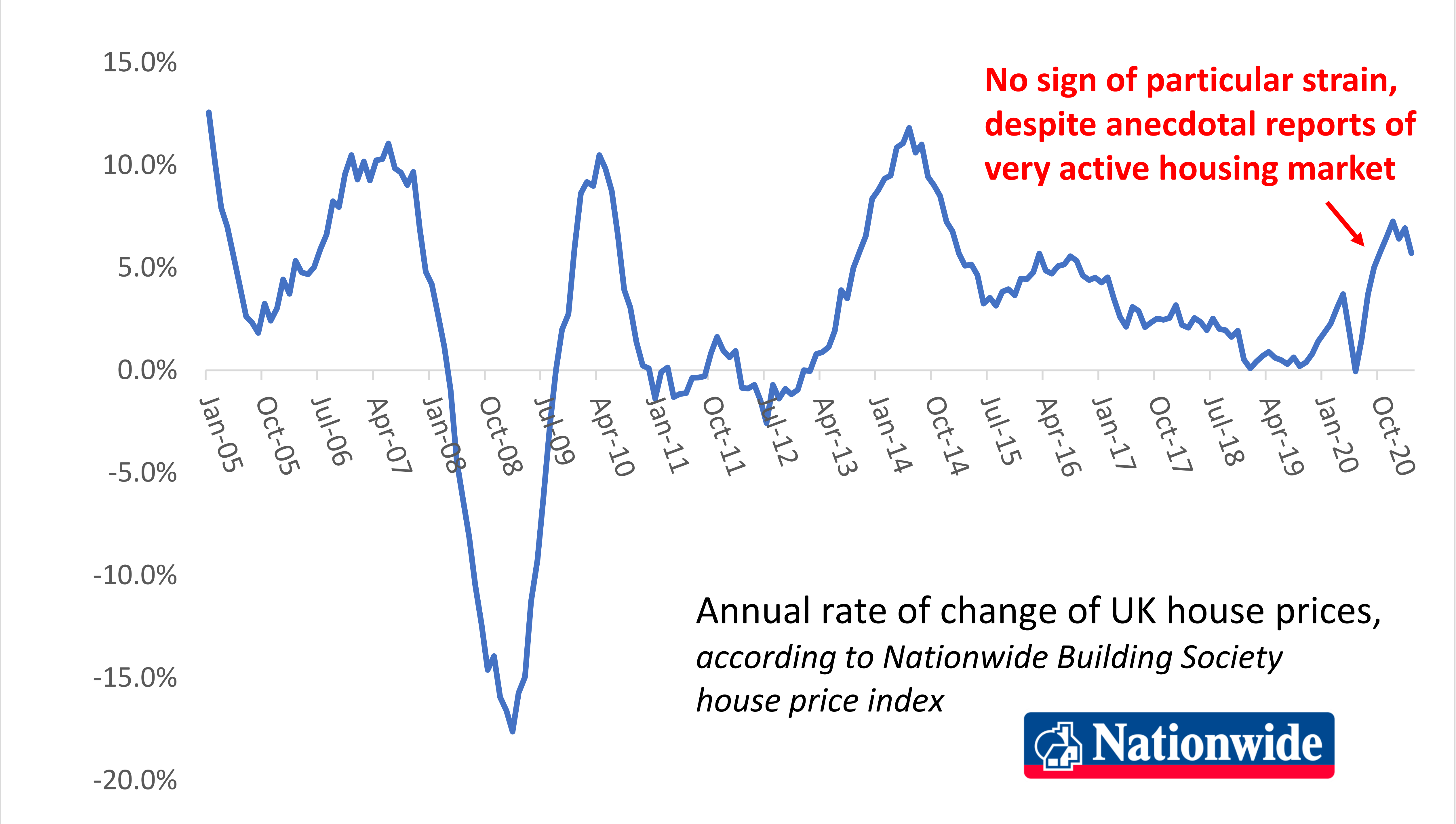
VERDICT:

Inflation will move up to the 3% - 6% vicinity in 2022 and 2023 in the context of

i. above-trend growth of UK domestic demand, and

ii. a global boom reflecting, above all, irresponsible fiscal and monetary policy in the USA, but also the breaking of the traditional (German-originated) rules of fiscal and monetary restraint in the Eurozone.

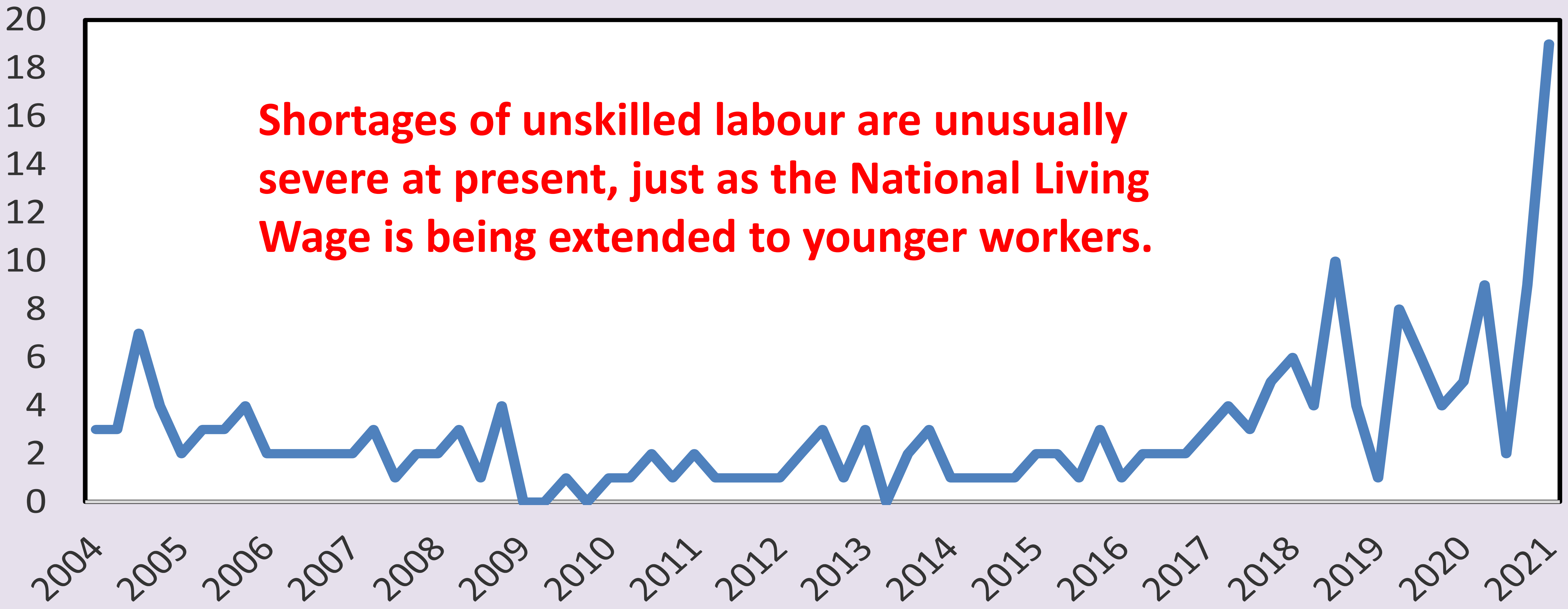
The FTSE100 has recovered strongly from March 2020 lows, but is only a little higher than it was 20 years ago. (The FTSE 250 has been stronger, but more volatile.)



No sign of particular strain, despite anecdotal reports of very active housing market
Annual rate of change of UK house prices,
according to Nationwide Building Society house price index
Nationwide
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
Jan-05
Oct-05
Jul-06
Apr-07
Jan-08
Oct-08
Jul-09
Apr-10
Jan-11
Oct-11
Jul-12
Apr-13
Jan-14
Oct-14
Jul-15
Apr-16
Jan-17
Oct-17
Jul-18
Apr-19
Jan-20
Oct-20

'Other labour', as a factor likely to constrain output, according to the CBI survey

- % of firms citing it as constraint on output



Are asset prices and the labour market telling us anything different?

- **Asset prices**

The stock market has recovered strongly from its March 2020 lows, but the FTSE 100 is *not* at new peaks. (The FTSE 250 is at new peaks.) The housing market is very active, but not booming.

- **The labour market**

Shortages of unskilled labour are severe – indeed, almost unprecedented – before the bounce-back from the Covid-19 restrictions is properly under way. This may be related to Brexit’s effect on migration.

Conclusions

- Assuming a return over the next few quarters to roughly 4%-a-year growth of broad money (i.e., of M4x),

- **It is very likely that inflation will exceed the top of the 1% - 3% band permitted by the inflation targeting regime**, and
- **It is also likely, although far from certain, that inflation will exceed 5% a year at some point in the next two/three years** – but much depends on

i. The conduct of policy, and particularly the rate of growth of broad money, from here, and

ii. Commodity prices and other international influences, over which our own policy-makers have little control.