INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

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

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Do interest rates or the quantity of money matter most in determining real private-sector demand growth in the UK?

A presentation by Professor Tim Congdon CBE,

Chair of the Institute of International Monetary Research,

in July 2022

A ‘wonk-ish’ presentation

- When he has a rather technical column in *The New York* Times, Paul Krugman warns his readers that it will be ‘wonk-ish’ – meaning that it will be for serious policy ‘wonks’…in anoraks etc.
- This video will be ‘wonk-ish’, in the Krugman sense. Indeed, unlike him, I will even be presenting some econometric results. So it will be ‘ultra-wonk-ish’.

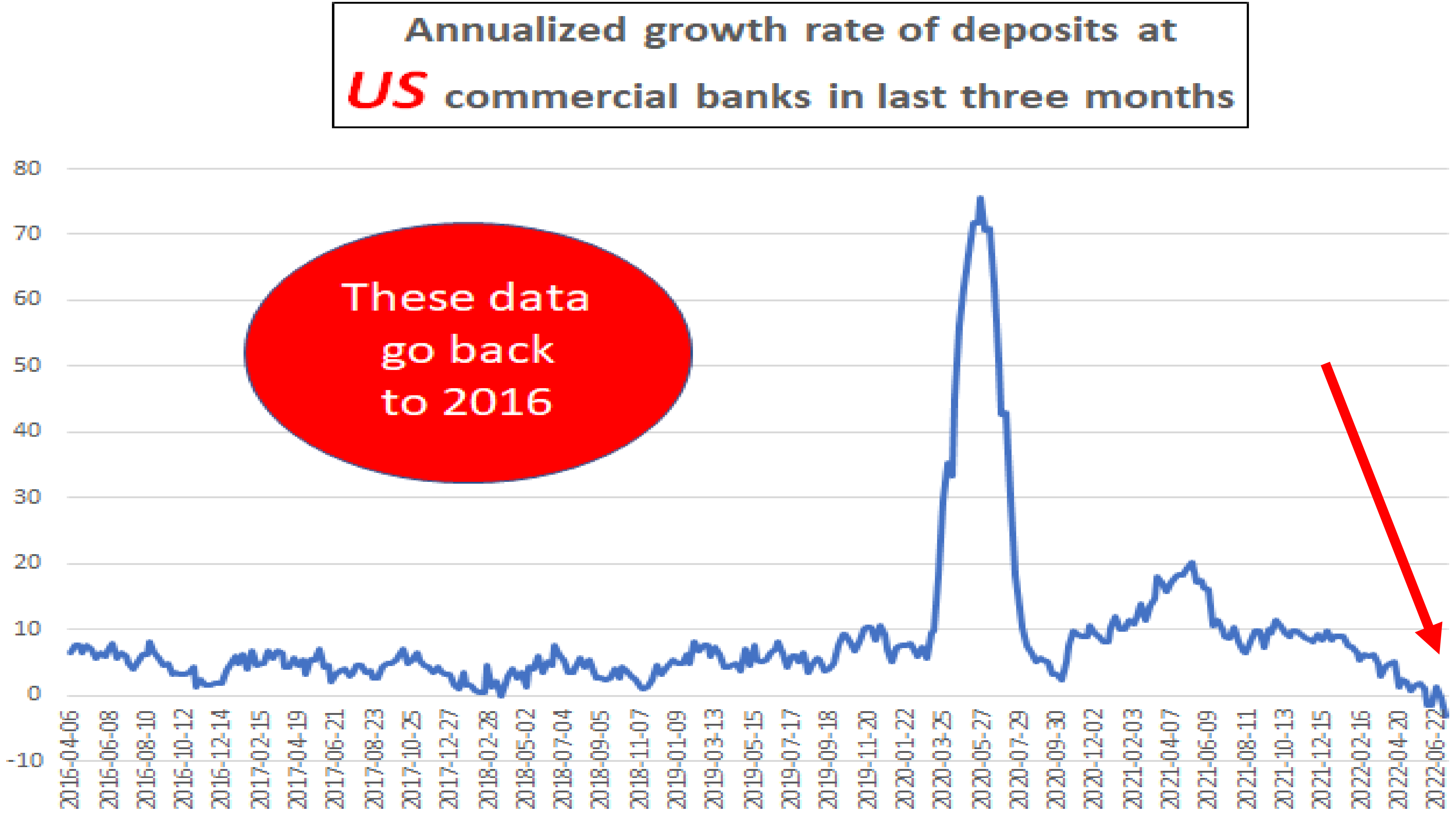
An intellectual challenge from Mr. Huw Pill, Chief Economist of the Bank of England

- Huw Pill is a British economist, and the chief economist of the Bank of England since September 2021. Pill studied philosophy, politics and economics at University College, Oxford, and graduated in 1989. He earned a doctorate in economics from Stanford University in 1995.
- Speech on 24 June, 'What did the monetarists ever do for us?'. Mostly unenthusiastic about monetarism, damning it with faint praise. It contained some remarks referring to the Institute of International Monetary Research

– and I want to respond.

An intellectual challenge from Mr. Huw Pill, Chief Economist of the Bank of England

- Excerpt from Huw Pill speech on 24 June, 'What did the monetarists ever do for us?'.
- "Interestingly, having been critical of the failure to tighten UK monetary policy in the face of strength in broad money growth through the pandemic, **one stream of British monetarist thinking now advocates a gradual tightening of policy, despite the current elevated level of inflation.** This preference for gradualism stems from the view that monetary growth has eased of late and strong policy action now risks tightening too much, inducing unnecessary macroeconomic volatility. This contrasts with the advice of others who advocate stronger immediate policy action in the face of elevated spot inflation."



Annualized growth rate of deposits at
US commercial banks in last three months
These data go back to 2016
80
70
60
50
40
30
20
10
0
-10
2016-04-06
2016-06-08
2016-08-10
2016-10-12
2016-12-14
2017-02-15
2017-04-19
2017-06-21
2017-08-23
2017-10-25
2017-12-27
2018-02-28
2018-05-02
2018-07-04
2018-09-05
2018-11-07
2019-01-09
2019-03-13
2019-05-15
2019-07-17
2019-09-18
2019-11-20
2020-01-22
2020-03-25
2020-05-27
2020-07-29
2020-09-30
2020-12-02
2021-02-03
2021-04-07
2021-06-09
2021-08-11
2021-10-13
2021-12-15
2022-02-16
2022-04-20
2022-06-22

The monetary situation *in the USA* at mid-2022

- Nominal money growth has collapsed – and in the last few months has been nil or even slightly negative.
- Meanwhile inflation is at its highest in 40 years…
- So real money balances are no longer soaring upwards as they were in spring and summer 2020, and for much of 2021. **Instead they are contracting, probably at the fastest rate for some decades and possibly ever.**
- **In my view, the negative effect on asset prices and aggregate demand of this squeeze on real money balances is already at work, and will smother the impact of small changes in Fed funds rate. By "small changes", I mean changes of 200/300 basis points.**

The problem with the Keynesians, particularly the New Keynesians

- Because of my focus on nominal/real money and its power over movements in nominal/real demand and GDP, I am not particularly concerned about interest rates. In my recent commentary, I have criticised – for example – Ken Rogoff of Harvard University. Rogoff in May 2020 advocated "deeply negative" interest rates of minus 5% to deal with the disinflationary effects of the pandemic, whereas now he supports 5% positive interest rates to check the inflationary sequel to the pandemic. He also complains that the Fed was too slow to respond to the signs of returning inflation in 2021!
- **What is Rogoff's problem? In essence, it is that he wants to comment on the evolving macro scene – but his analyses have no role for money. So he lurches around with volatile recommendations on interest rates (and fiscal policy!) as unexpected news comes along….**

The quantity of money vs. ‘interest rates’: a view from Anna Schwartz

- Schwartz wrote a paper in 1969, on the tenth anniversary of the 1959 report of the UK's Radcliffe Committee, which included the observation

- **“The correlations between the level or rates of change in interest rates, on the one hand, and rates of change in nominal income, prices and output, on the other, are considerably worse than those between rates of change in the quantity of money and these magnitudes.”**

The quantity of money vs. 'interest rates': a view from Huw Pill

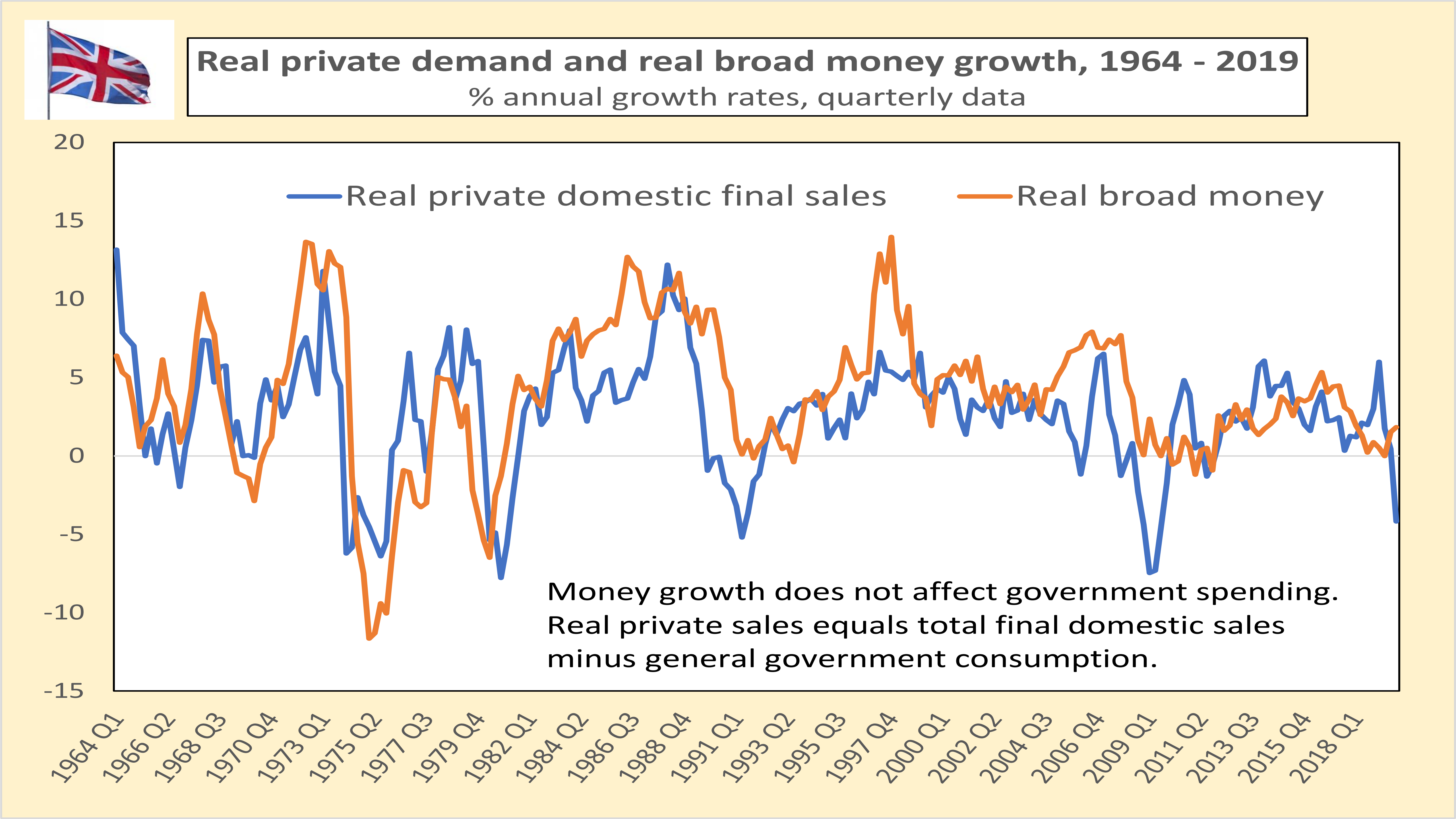
- Another excerpt from Huw Pill speech on 24 June, 'What did the monetarists ever do for us?'.
- Some insights into the effects of volatility in the demand to hold money have "long been embedded in central bank practice, **with short-term interest rates being the operational instrument of monetary policy.** And it is now central to the canonical model of monetary policy outlined in [Michael] Woodford's *Interest and Prices,* which both captures and has catalysed the large and still growing literature on interest rate rules for monetary policy."

The quantity of money vs. ‘interest rates’: part of my response

‘Interest rates or quantity of money?
Edward Nelson on Milton Friedman’, pp. 320 – 35,

Journal of Economic Affairs
(London: Institute of Economic Affairs), vol. 41, no. 3, 2021.

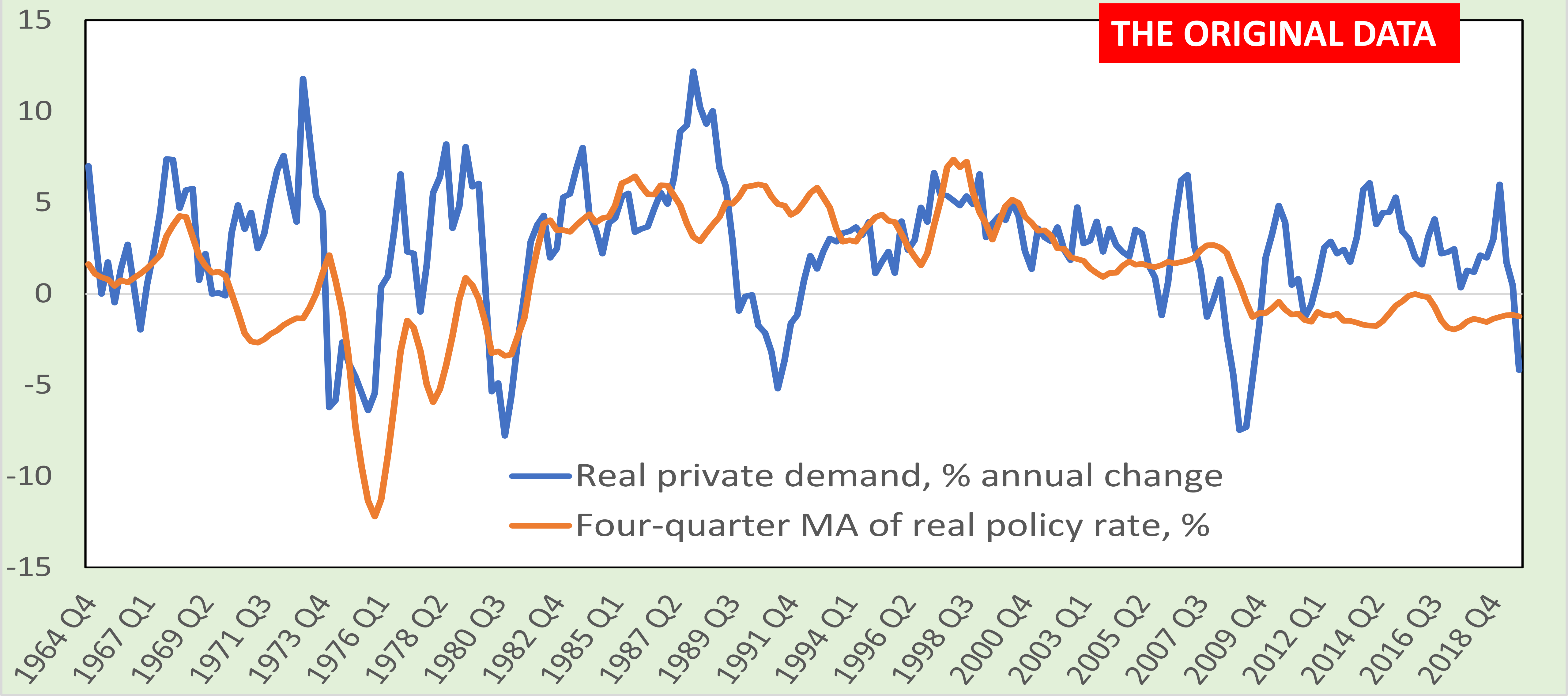
MY 2021 ARTICLE WAS CONCERNED WITH THE AMERICAN DATA. I SHOWED THAT ANNA SCHWARTZ’S GENERALISATION IN 1969 HELD TRUE IN THE FOLLOWING 50 YEARS TO 2019.



Real private demand and real broad money growth, 1964 - 2019
% annual growth rates, quarterly data
Real private domestic final sales
Real broad money
20
15
10
5
0
-5
-10
-15
1964 Q1
1966 Q2
1968 Q3
1970 Q4
1973 Q1
1975 Q2
1977 Q3
1979 Q4
1982 Q1
1984 Q2
1986 Q3
1988 Q4
1991 Q1
1993 Q2
1995 Q3
1997 Q4
2000 Q1
2002 Q2
2004 Q3
2006 Q4
2009 Q1
2011 Q2
2013 Q3
2015 Q4
2018 Q1
Money growth does not affect government spending.
Real private sales equals total final domestic sales
minus general government consumption.

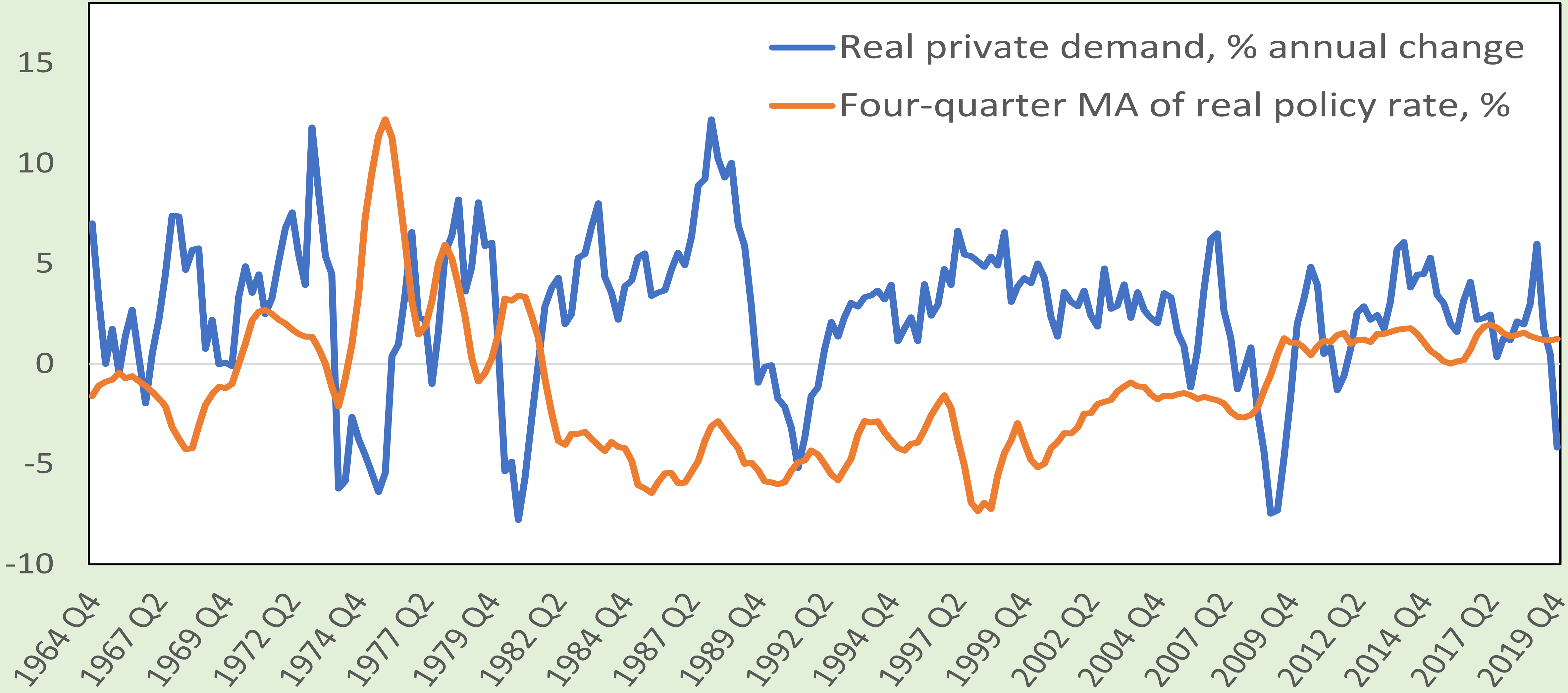
Real private demand and real official policy rate, 1964 - 2019

Quarterly data, with average of previous four quarters
to represent policy rate for quarter



Real private demand and real official policy rate, 1964 -2019

Quarterly data, with average of previous four quarters
to represent policy rate % for quarter, policy rate inverted



The quantity of money vs. 'interest rates': a statistical result for the UK, 1964 - 2019

- The change in real private demand (% p.a.) was regressed on i. the change in real broad money (% p.a.), with no lag, and ii. the real policy rate, with the real policy rate being the four-quarter average before the quarter in question. The resulting equation was:

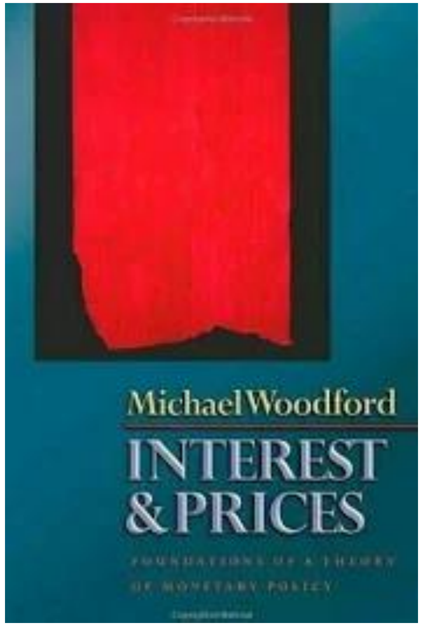
Change in real private demand, % p.a. = 0.72 + 0.49 Change in real broad money, % p.a. – 0.09 Real policy rate

- r^2 (correlation coefficient of the equation) –		+0.35
- t statistic on: intercept term	2.80	
: Change in real money	9.41	
: Real policy rate	-1.29	

Note that the coefficient on the real policy rate was hardly different from zero and was not statistically significant.

The quantity of money vs. ‘interest rates’: a view from Huw Pill

- Another excerpt from Huw Pill speech on 24 June, ‘What did the monetarists ever do for us?’.
- Some insights into the effects of volatility in the demand to hold money have “long been embedded in central bank practice, **with short-term interest rates being the operational instrument of monetary policy**. And it is now central to the canonical model of monetary policy outlined in [Michael] Woodford’s *Interest and Prices,* which both captures and has catalysed the large and still growing literature on interest rate rules for monetary policy.”



Interest rates vs. QE and QT, as components of monetary policy

- **The relationship between changes in real broad money and real demand is much stronger than that between any interest rate concept (level or changes) and changes in real demand. This is an enduring result, noticed by Anna Schwartz over 50 years ago, but easy to confirm from data for subsequent decades.**
- Changes to official policy rates will affect the growth of bank lending to the private sector – and hence the rate of money growth. Of course they matter to monetary policy.
- But operations such as those contained in ‘quantitative easing’ and ‘quantitative tightening’ also affect the rate of money growth, and arguably they do so more directly and with greater precision. They too matter to monetary policy.

Interest rates vs. QE and QT, as components of monetary policy

- **This is not a new topic.** QE/QT operations used to be known in the 1970s and 1980s as 'funding operations' which would affect the rate of money growth. Sales of public sector debt to non-banks in excess of the PSBR (i.e., the budget deficit) reduced the quantity of money and were known as 'over-funding'. If sales of public sector debt to non-banks were less than the PSBR, the state's financial activities increased the quantity of money, a condition that might be termed 'under-funding'.
- **'Over-funding' (i.e., 'quantitative tightening') was important in the early 1980s in keeping the rate of money growth down. It was a well-known policy instrument in the era of broad money targets.**

Interest rates vs. QE and QT, as components of monetary policy

- **In summary,**

-QT = Over-funding in 1980s' parlance, and

-QE = Under-funding.

Interest rates vs. QE and QT, as components of monetary policy

- When over-funding stopped in 1985, the rate of broad money growth accelerated.
- **I was appalled by what the government and Bank of England were doing, and said that the acceleration in money growth implied a boom and a future acceleration in inflation. A boom then followed, the so-called 'Lawson boom', after the Chancellor of the Exchequer who presided over it.**
- ***My forecasts were correct, as they have been again in the current episode.***

Inconsistency and dishonesty in the Bank of England's treatment of these matters

- Like Andrew Bailey, the Bank's Governor, **Mr Pill believes – according to his 24 June speech on the monetarists – that the current inflation over-shoot is due to external shocks, not excessive money growth.**
- If so, it seems to me strange that Mr Pill should devote much of his speech to discussing QE and QT, where he does in fact concede that these work via a so-called 'portfolio balance effect' and the analysis has to be largely monetary, i.e., referring to the effects of changes in the quantity of money on asset yields and prices.
- **If inflation is caused by external shocks, why did Mr Bailey use the Mansion House speech to commit the Bank of England to substantial sales of gilt-edged securities from its special facility?**

Inconsistency and dishonesty in the Bank of England's treatment of these matters

- **REPEAT: If inflation is caused by external shocks, why did Mr Bailey use the Mansion House speech to commit the Bank of England to substantial sales of gilt-edged securities from its special facility?**
- The Mansion House speech was entitled, 'Bringing inflation back to the 2% target, no ifs, no buts'.
- **If rapid inflation has been 80% caused by external shocks, why is Mr. Bailey telling us that net gilt sales of £50b. - £100b. from the Bank's facility are part of his organization's efforts to bring inflation back to 2%?**
- **He (and Mr. Pill) should be honest – that the QE asset purchases were much too large in 2020 and 2021, and so led to excessive money growth. *Excessive money growth has been the main cause of the current inflation upturn.***