International Monetary Monitor

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SMPC: International & UK Backdrop

By John Greenwood

Introduction and Overview

- On October 15 the Shadow Monetary Policy Committee of the UK, which "shadows" the Bank of England's MPC, met at Institute of Economic Affairs in London, three weeks ahead of the Bank's MPC meeting on 5-6 November.
- Our practice is for one individual to summarise the economic and monetary background for the other SMPC panel members. Following a discussion, participants then vote on what they view as the desired actions of the Bank of England.
- On this occasion I was invited to make the presentation. Today, 10 days later, I thought it would be interesting for readers to look over my shoulder.
- I began with the contrast between the consensus framework and the monetarist framework. In my view, the latter explains better the divergent increases in price levels in different countries over the past four years.
- My next objective was to show that the likely trend in the nominal GDP of the international economic system over the next 12-18 months would be dominated by the downswing in monetary growth over the past 18 months.
- Commodity prices, US retail sales, and global trade illustrated the start of these trends.
- Shifting to the UK, I showed that each element of the monetary transmission mechanism was conforming to the monetary framework: the change in money holdings, the movement of asset prices, trends in real and nominal GDP, consumer and capital spending, and UK trade.
- I also showed that the labour market was reverting to its pre-Covid norm.
- Finally, I argued that a repetition of "austerity" – the policy allegedly implemented after 2010 by the Tory government – could only occur if monetary growth was restrictive in the way that it had been in 2010-14.
- My vote, based on the above arguments, was for a further cut of 0.25% in Bank rate and a recommendation to terminate QT, the policy of shrinking the Bank of England's balance sheet by £100 billion between October 2024 and September 2025. The priority should be to ensure M4x growth at 4-6% p.a.

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Introduction: Two Different Frameworks.

The dominant consensus explanation for the inflation of the past 3-4 years is that it was caused by a series of shocks, some triggered by the pandemic, some triggered by the war in Ukraine, that affected the relative prices of major commodities (such as electronic chips, oil and gas, and food prices), which in turn fed through to an increase in the overall price level.

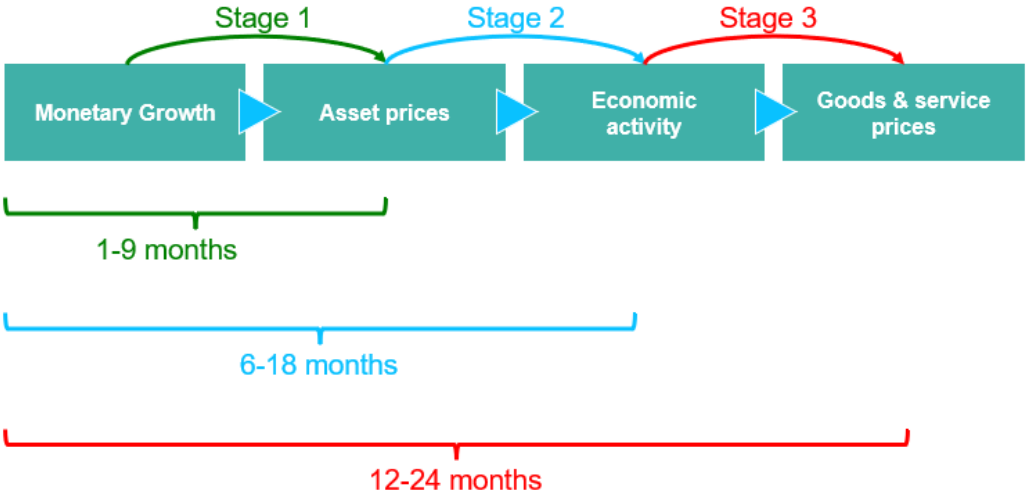
Figure 1. *Ad hoc* explanations for inflation have proliferated; but the *only cause* of inflation is excess money.

Timing	Alleged "cause" of inflation	Monetary view
Pervasive throughout the pandemic, with numerous episodes, dependent on local budgetary processes.	**Fiscal support measures** such as furlough payments to households; loans, grants and other support to corporations.	Fiscal spending on its own is a ***transfer*** from private to public sector. It is not "stimulatory" unless financed through the banking system by the acceleration of broad money growth.
From start of pandemic until early 2022 (in most economies)	**Interest rates kept too low for too long.** WRONG: the damage was already done in 2020-21 by excessive increases in broad money in the US, UK, euro-area, Canada, Australia, NZ etc. – all due to QE	Central banks pay far too much attention to rates and yields, not enough to the **quantitative** dimension of monetary policy. They ignored rapid growth of money in 2020-21, initially asserting that the pandemic would be a deflationary event.
From late 2020 thru 2021-22 and into 2023 & 2024.	**Labour "shortages"** due to workers not returning to the workforce, or due to long-term sickness.	Total spending is determined by money growth and income velocity. Any decline in output due to labour shortages has been far smaller than either the increase in money or the changes in velocity.

In my view, the framework in Figure 1 above is fundamentally flawed. There is a much more straightforward explanation. In response to the pandemic many central banks adopted highly expansionary monetary policies, notably large-scale asset purchases of securities from non-banks, colloquially known as Quantitative Easing or QE, which led directly to substantial increases in broad money. In some cases, such as the ECB or the Bank of Japan, the same effect was achieved through central bank lending to the commercial banks on condition that they in turn ensured that their lending to private firms also increased *pari passu*. Both policies led to large increases in bank deposits – i.e., increases in broad money growth.

Large increases in broad money invariably lead to a chain reaction illustrated in Figure 2. The first impact is that money holdings of the non-bank public increase, and those excess money holdings tend to be spent, in the first instance, on the purchase of assets such as equities, bonds, or real estate. This effect occurs over a period of 1-9 months, though it may be extended if the rapid monetary growth continues for longer.

Figure 2. The Monetary Transmission Mechanism.



The second effect is on economic activity. The rise in asset prices tends to persuade people and businesses that they have become richer and are now in a position to spend more on a regular basis. As a result, after a period of 6-18 months, investment spending and consumption spending both tend to increase, and firms may hire more employees to cope with what they perceive to be a permanently higher demand for their products and services.

In contrast with asset prices which have no upside limit, economic activity is constrained by the productive potential of the population – by productivity and by the size of the labour force. Consequently, when shortages arise, prices are driven upwards.

This leads to the third set of effects: inflation of goods and service prices in the case of a monetary expansion, disinflation or even deflation in the case of a monetary slowdown or contraction. These effects tend to occur after a period 12-24 months, but there is a high degree of variability in the length of the lag. In countries where inflation has recently been high the lag will tend to be relatively short; in countries where inflation has been very low, the lag will tend to be relatively long.

Section 1. The International Environment.

By far the most important determinant of the different inflation rates around the world in the past four years has been the differing growth rates of broad money. We begin with the contrast between money growth rates in the US, the UK, and the eurozone on the one hand and money growth rates in China, Japan and Switzerland on the other.

There is no doubt that the timing of the pandemic, the start of the war in Ukraine, the relative real economic and labour force growth rates of the individual economies etc. all played a role in influencing the precise profile of inflation in particular countries. But when these factors are accounted for, the overwhelming driver of inflation is the broad money growth rate in each case (see Figures 3 and 4).

Figure 3. Economies with Relatively Higher Money Growth Rates Experienced Higher Inflation.

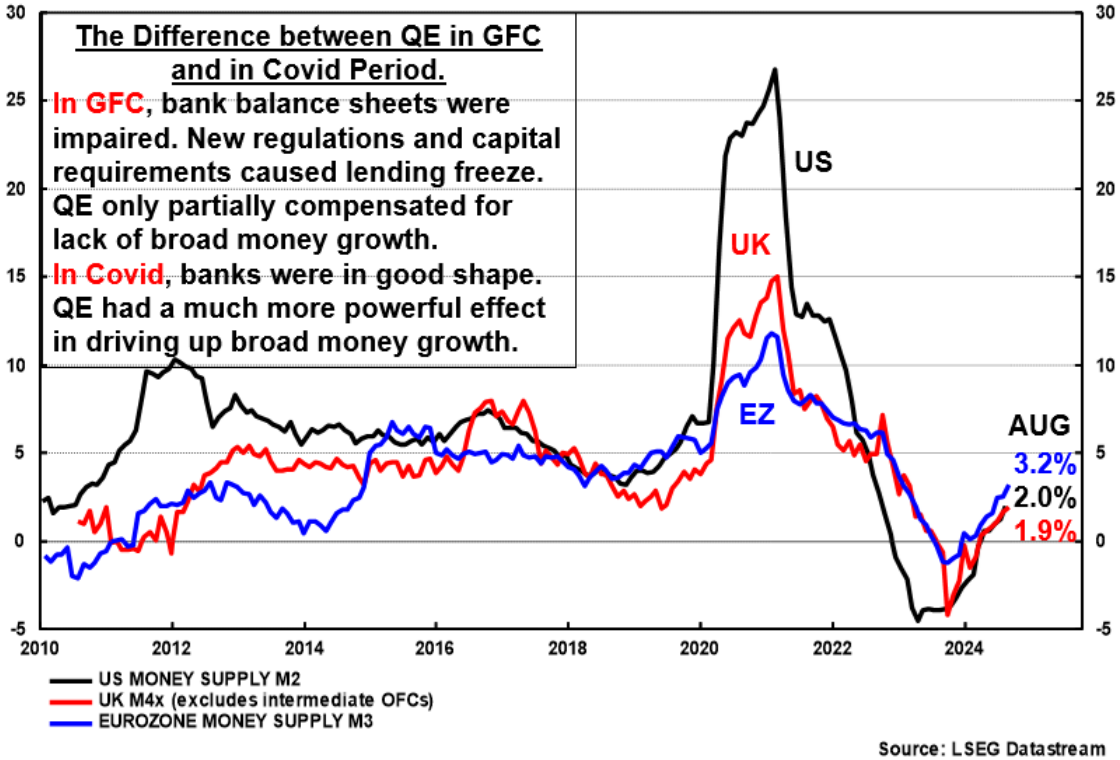


Figure 4. Economies with Relatively Lower Money Growth Rates Experienced Lower Inflation.

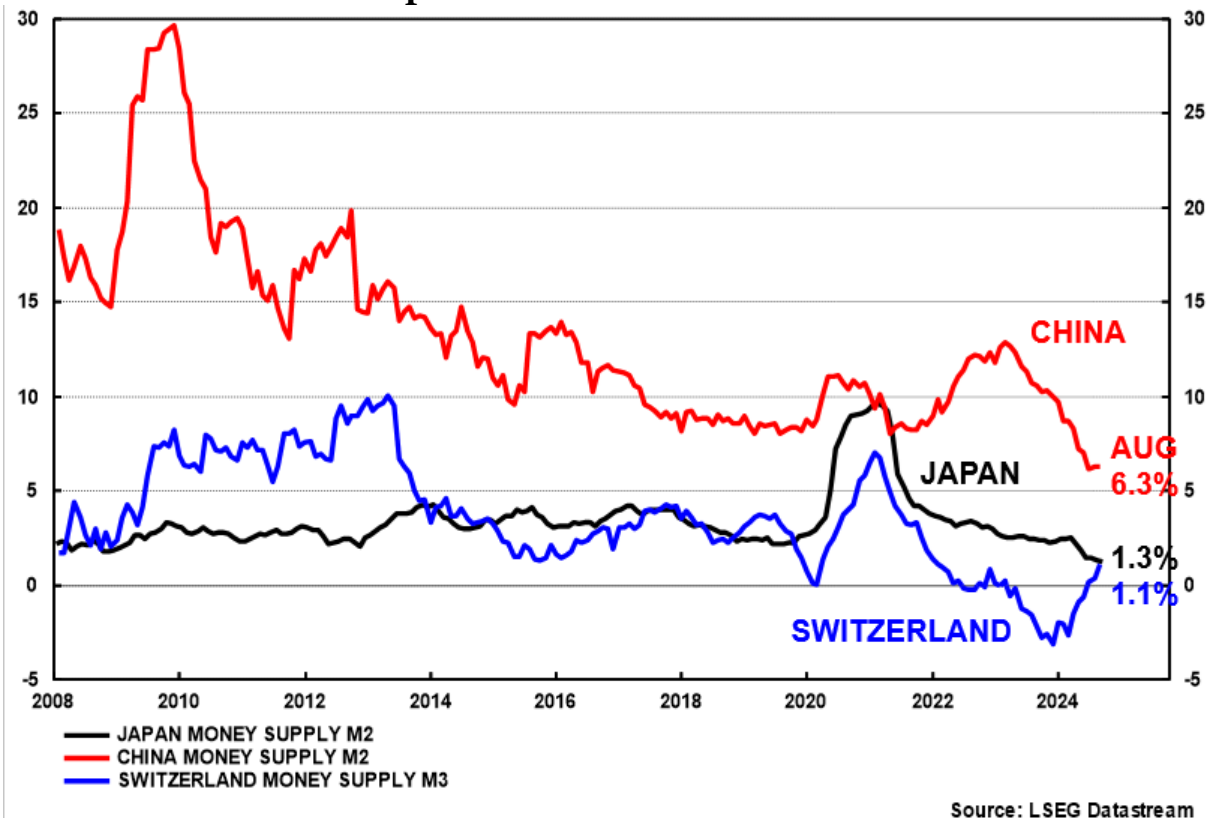
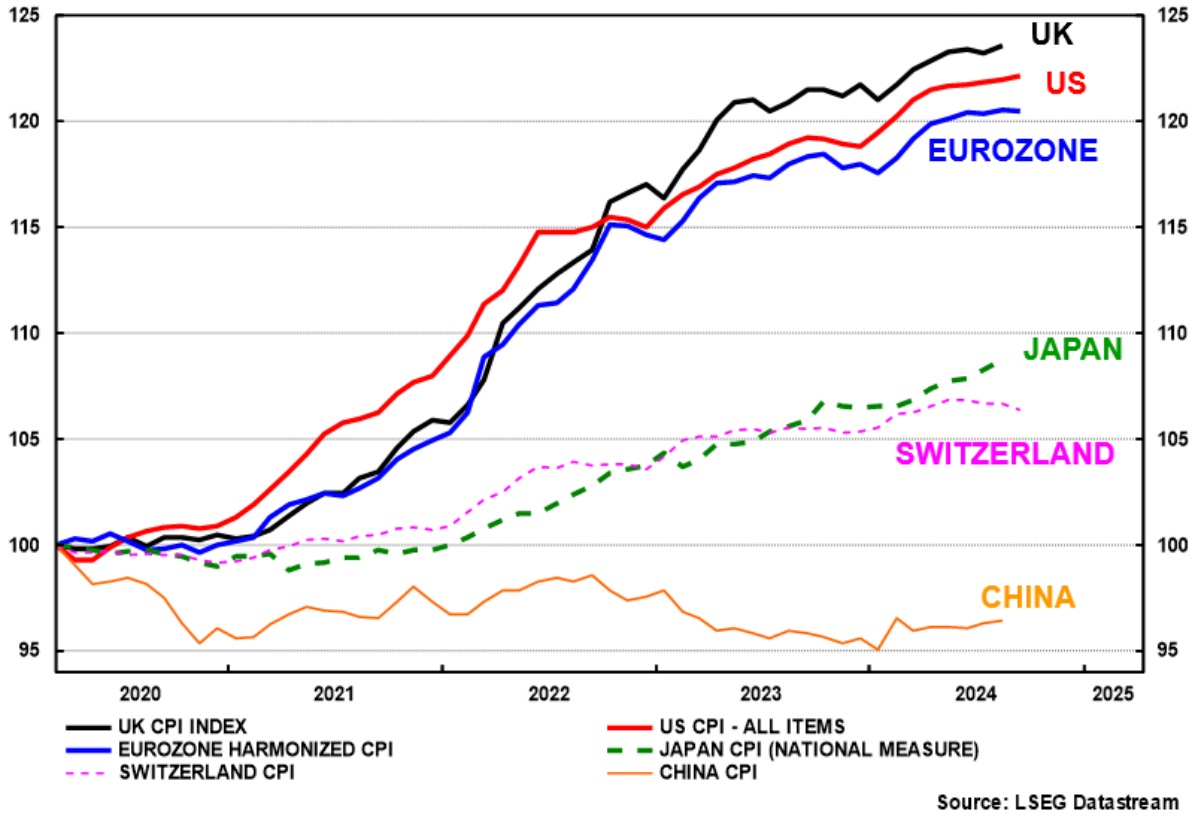


Figure 5. Comparison of Price Levels in US, UK, Eurozone, Japan, China and Switzerland.
(INDEX LEVELS, MARCH 2020=100)



As Figure 5, shows, the US, the UK and the eurozone have experienced increases in their consumer price levels of between 20% and 24% between March 2020 and August 2024, whereas Japan and Switzerland have seen their CPIs rise by 6-8% while China has seen its consumer price index *fall* by about 4% over the same period.

The first three economies experienced the highest relative money growth rates of the six under comparison in Figures 3 & 4. But the inflation rates are not solely determined by the money growth rates. They are the outcome of changes in the quantity of money after changes in money holdings and changes in economic growth have been taken into account, as prescribed by the quantity theory of money: MV=yP.

Thus although China, Japan and Switzerland saw absolute increases in their broad money supplies, and both Japan and Switzerland witnessed accelerations of money growth in the immediate aftermath of the onset of the Covid pandemic, much more of the change in money growth was absorbed either by increases in real economic growth (China), or by increases in money holdings (China and Japan), ultimately resulting in lower overall CPI inflation.

To see the overall trends of spending (yP) likely in the next 12-18 months, compare smoothed money growth rates with smoothed growth rates of nominal GDP in Figures 6 & 7.

Figure 6. Broad Money Growth is the Dominant Driver of Nominal GDP.

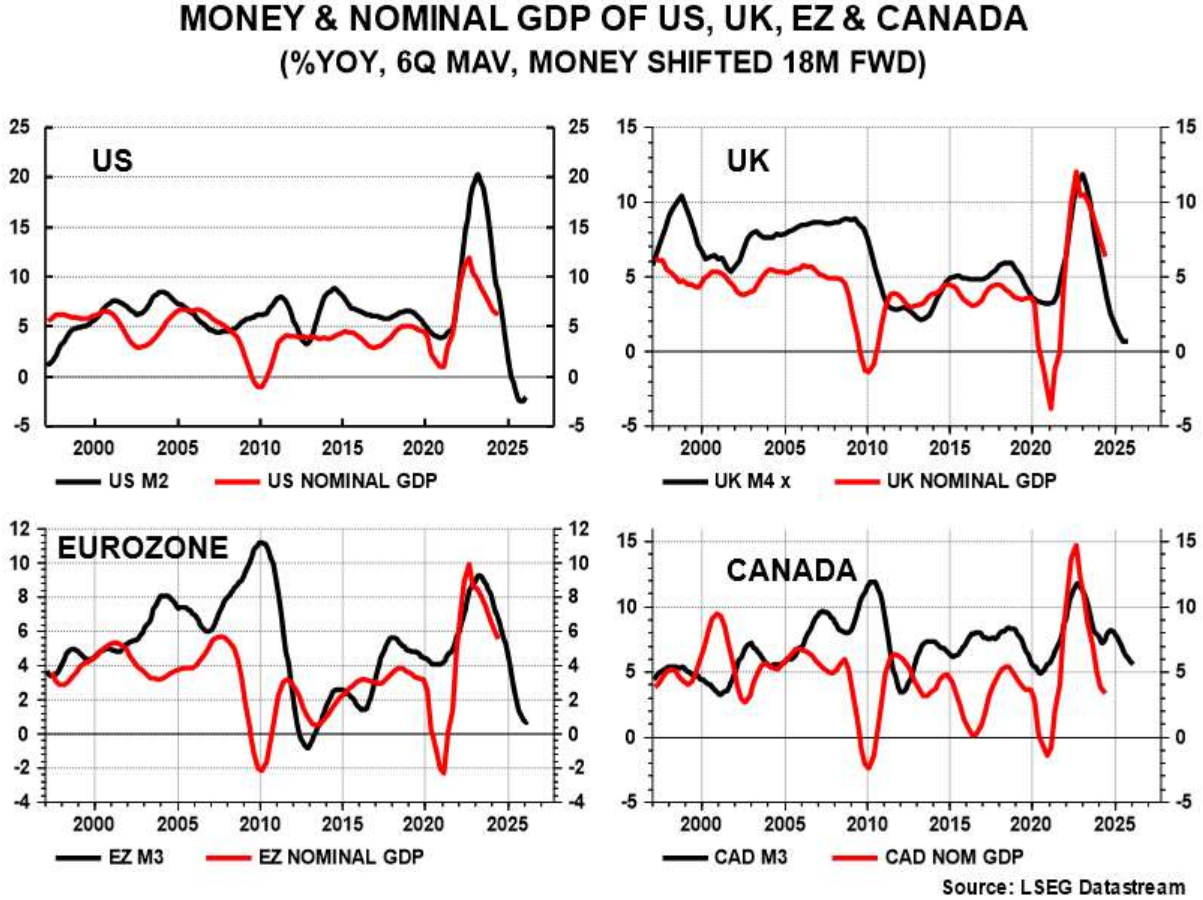


Figure 7. Broad Money Growth Dominates Nominal GDP Trends.

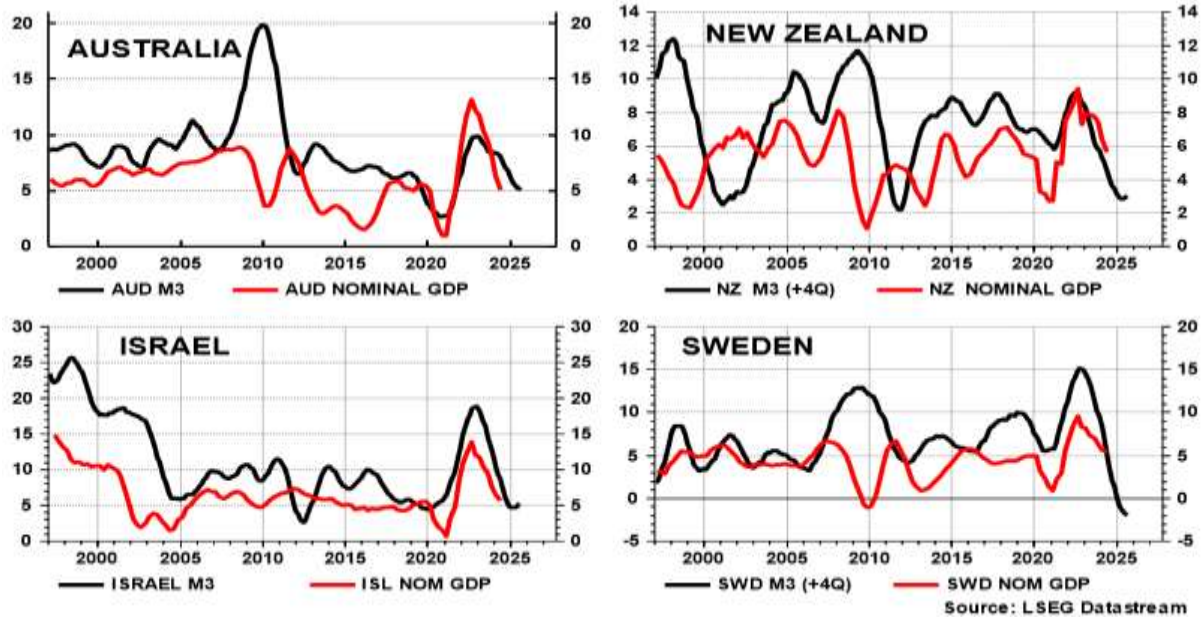


Figure 8 presents the same data for four economies, this time including India, which did not experience egregious increases of broad money growth during the pandemic.

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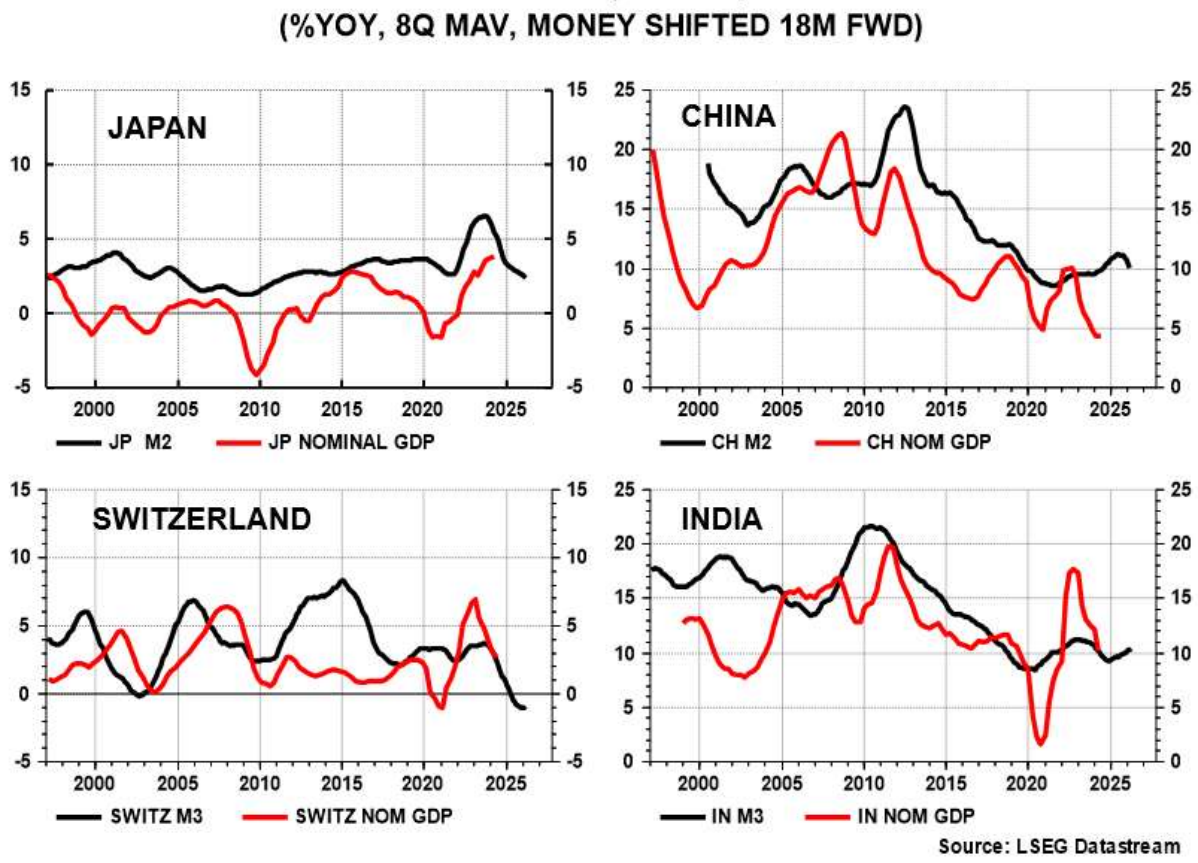
Figure 8. Even in Low Inflation Economies, Money Growth Dominates.



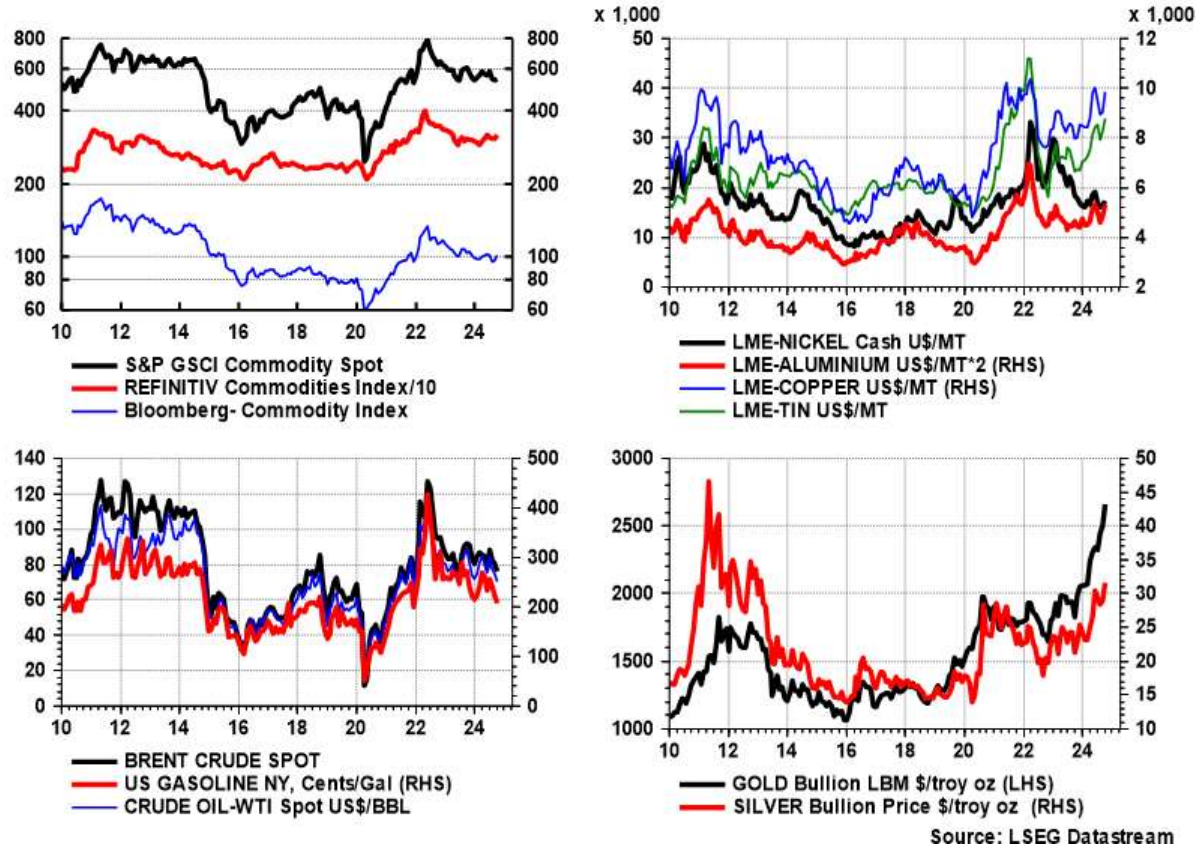
Summarising the message of the trends shown for the 12 economies in Figures 6-8, we can split the effects of slowing money growth into the effects on real GDP growth and the effects on inflation.

In almost all cases the broad money growth rates (in black) are pointing to further slowdowns of nominal GDP (in red). Since we know from monetary theory (Figure 2) that cyclical changes in real GDP growth tend to follow changes in broad money growth with a lag of 6-18 months, we can predict with reasonable confidence (i) that growth in much of 2025 will remain subdued. Of course, interest rates are likely to be declining, and this may give encouragement to entrepreneurs to expand their operations, but the boost to real GDP will be limited by the restrictive money growth.

Further, since we also know that the lag in effect between changes in money growth and changes in inflation are generally 12-24 months, and that money growth rates in almost all cases have declined from their recent peaks, inflation rates in all the featured economies are also likely to be falling or remain low over the most of the next two years. The risks, much talked about by leading central bankers, of a set of "second round effects" pushing up inflation can be effectively ruled out. Of course, random shocks

may occur affecting some key prices, such as oil prices, but the overall price level will not be affected unless such increases are accommodated by further monetary expansion.

Figure 9. Except for Precious Metals, Commodity Prices are Subdued.



We do not have global house price indices, but commodities are purchased and used in all economies, so commodity prices give us an indication of the strength of global demand. Figure 9 shows some well-known commodity price indices in the top left (in USD), with oil prices (lower left), industrial metals (upper right) and precious metals (lower right). Except for precious metal prices which are reacting to the prospect of falling interest rates (among other things), most commodities are remarkably calm considering the geo-political disruptions of the past two years. This is consistent with the message of softer aggregate demand coming from slower broad money growth.

On the domestic front, it is interesting to compare the shape of the US monetary acceleration of 2020-22 with the subsequent surge in US retail sales (Figure 10, PTO). The dashed line is an extrapolation of the trend in pre-Covid retail sales. Logically the relationship between broad money and nominal retail sales is a subset of the relation between money and nominal GDP, but it is remarkable how often the same shape re-appears once it has been identified. The same profile can be seen in the growth of world trade since the start of the Covid pandemic (Figure 11, PTO).

Figure 10. US Broad Money Growth Has Helped Drive US Retail Sales.

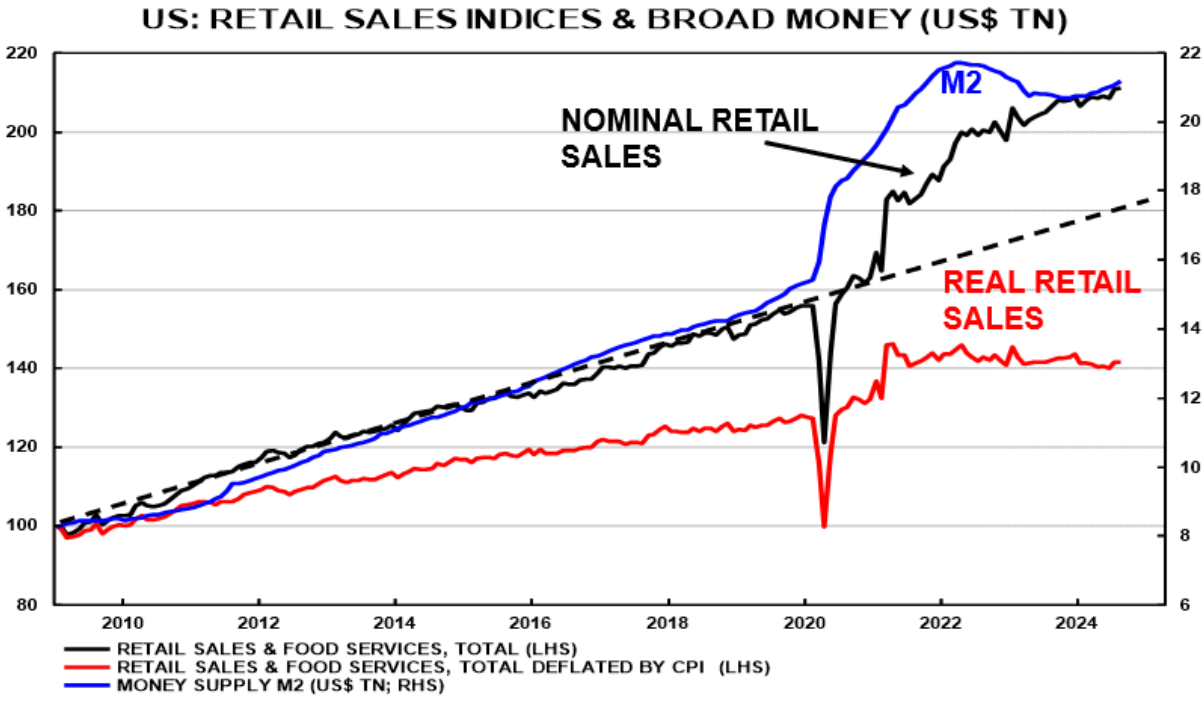
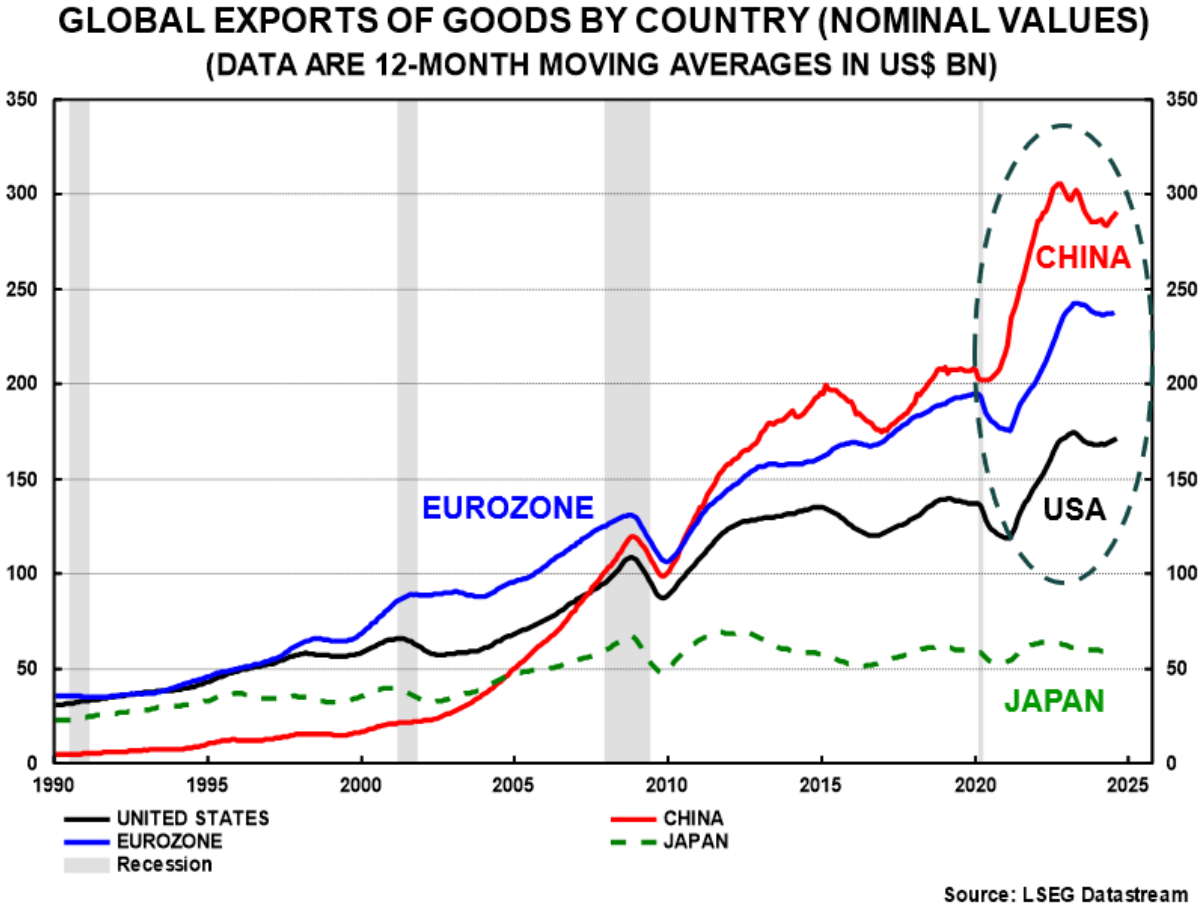


Figure 11. Global Trade has Largely Danced to the Tune of Money Growth.



Section 2. The UK Monetary and Economic Environment.

When Governor Bailey and the Bank of England embarked on large-scale asset purchases in March 2020 – "Going Big" as the Governor called it – the scale of money creation was unprecedented in modern times. As a result, money holdings built up in the hands of firms and households. Expressed differently, the income velocity of circulation fell (Figure 12) in 2020-21 and increased in 2022-23.

Figure 12. Velocity First Falls then Increases after Large Increases in M4.

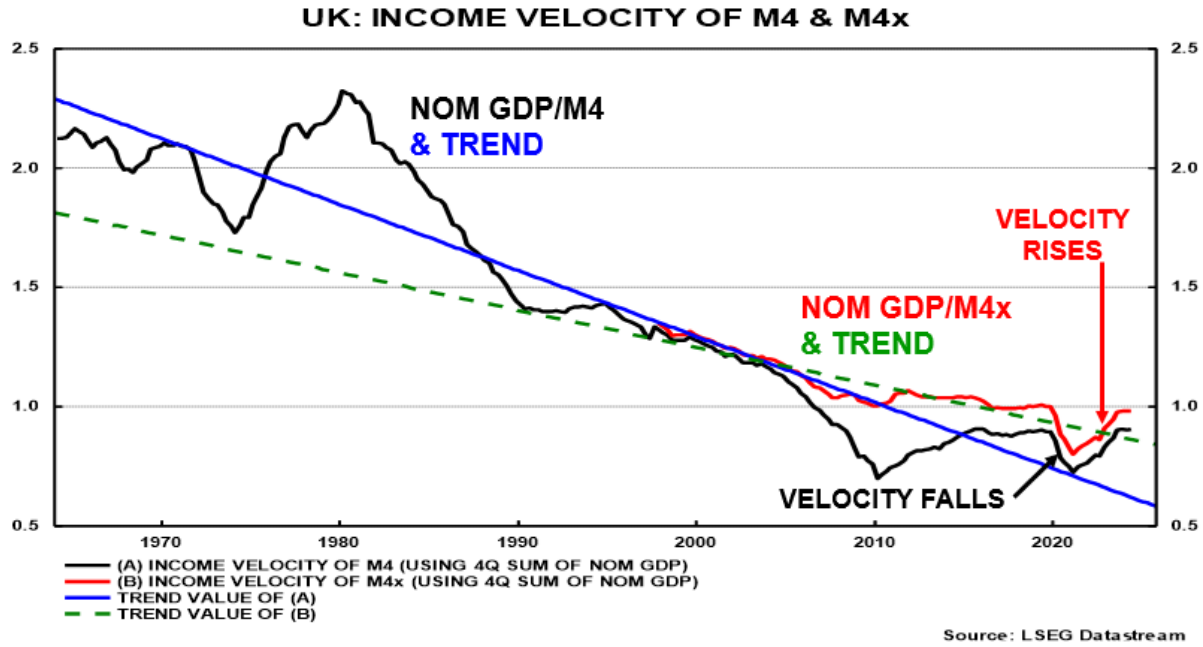


Figure 13. Matching the Trend in Money Growth, House Prices Surged in 2020-21 but have Fallen Back in 2022-24.

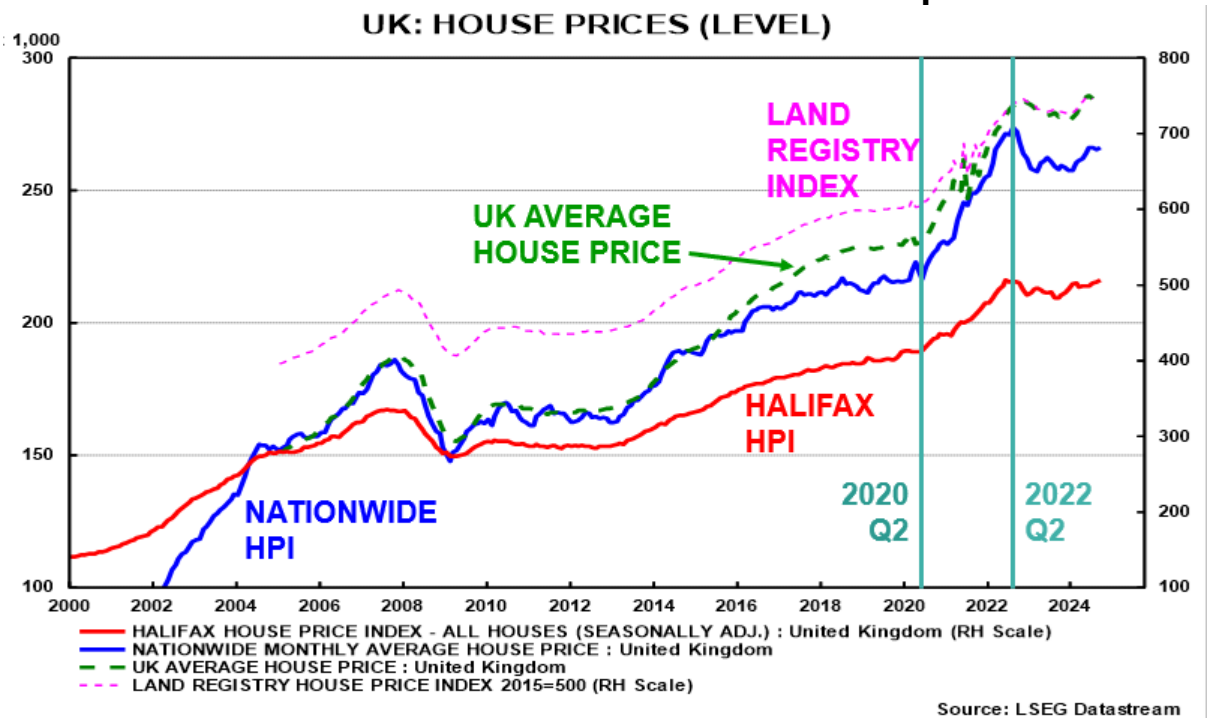
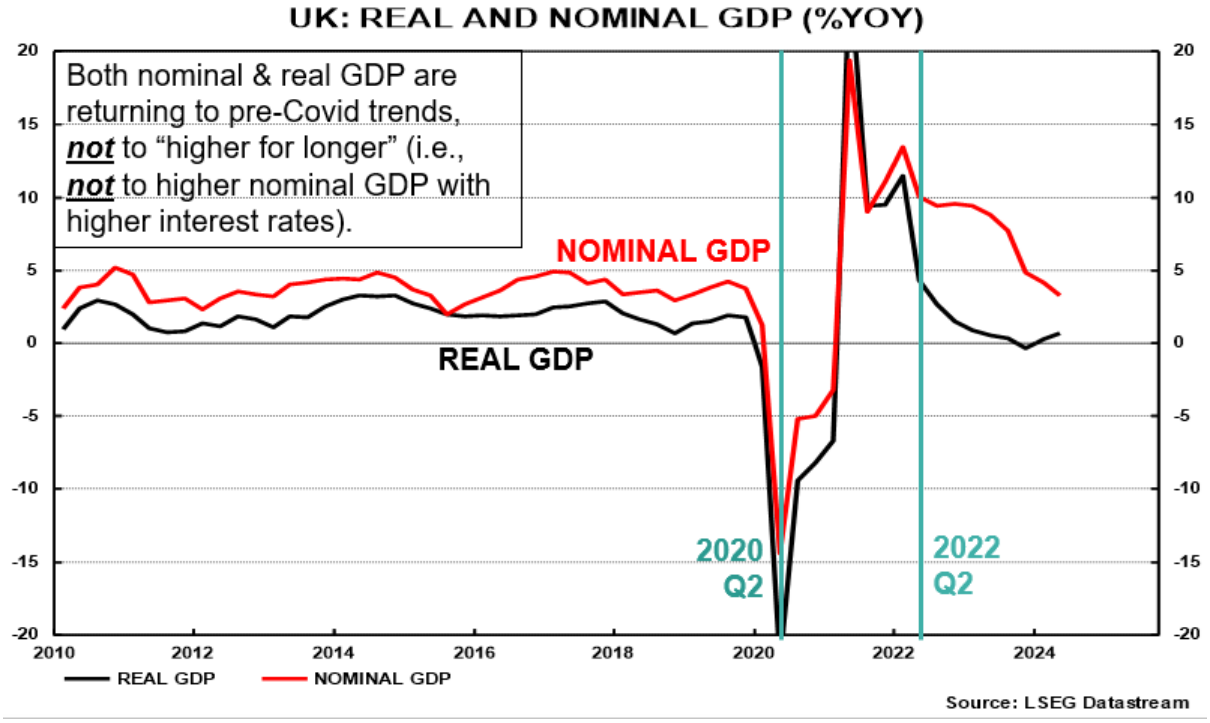


Figure 13 shows the impact of the sudden surge in broad money growth on UK asset prices, for which I have selected house prices. All the major indices show a big rise between 2020 Q2 and 2022 Q2, which then tailed off as the Bank of England raised rates, reversed QE and slowed money growth. House prices are especially interesting for monetary analysis because they cannot be explained by the false narrative of external, or global shocks, and can only be explained by changes in domestic monetary conditions. It should also be mentioned that I have not used equity prices because they are heavily affected by (a) sales and corporate earnings trends overseas, and (b) the performance of other stock markets.

Figure 14. UK Nominal and Real GDP have Conformed to Monetary Trends.



As we saw in Figure 2 (p.3), after affecting asset prices, the next impact of changes in money growth are on economic activity. Figure 14 shows nominal and real GDP before, during and after Covid. Initially in 2020 there were three phases of lockdown, leading to a sharp decline in real (and nominal) GDP as people were forced to stay home. The effect was particularly severe in the UK which is a heavily service-dominated economy. However, once the lockdowns were lifted and Covid-vaccines introduced, the economy bounced back very strongly. Such strong economic activity was not sustainable and from mid-2022 there was an appreciable weakening of economic activity coincident with the tightening of policy by the Bank of England. Since then, economic activity has been fairly subdued reflecting the tightness of monetary policy, the large number of people that have not returned to work, and the continuing problems of low productivity growth.

One notable feature of Figure 14 is the narrowing gap between nominal and real GDP – i.e., the slowdown of inflation as measured by the GDP deflator, which brings us to the final effect of changed money growth on the economy. However, before dealing with inflation, we will make a detour to look at consumption, investment, and trade.

Figure 15. UK M4x and Consumption Indicators

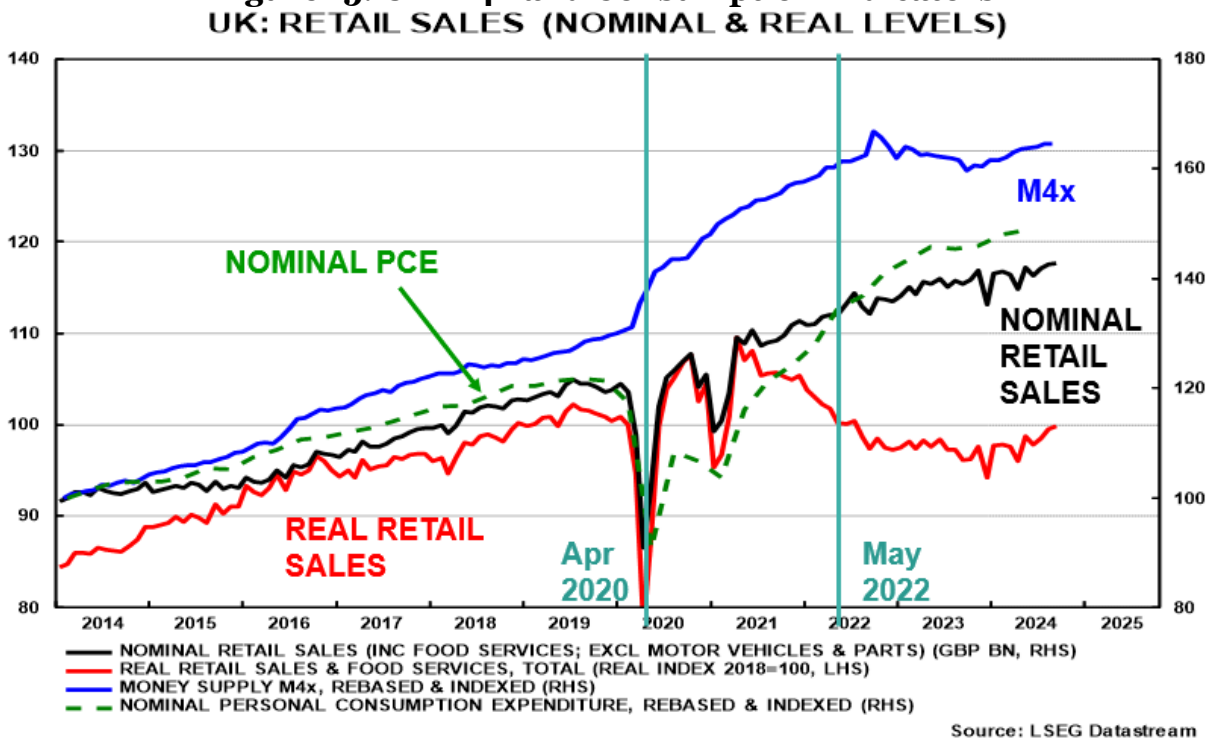


Figure 15 shows key UK consumption indicators while Figure 16 shows investment indicators from the GDP statistics. Both charts demonstrate how real growth has remained very modest, but nominal PCE growth and retail sales continue to rise thanks only to money growth driving up the inflation component of each indicator.

Figure 16. UK Real Investment Spending Remains Subdued in the Aftermath of Covid.

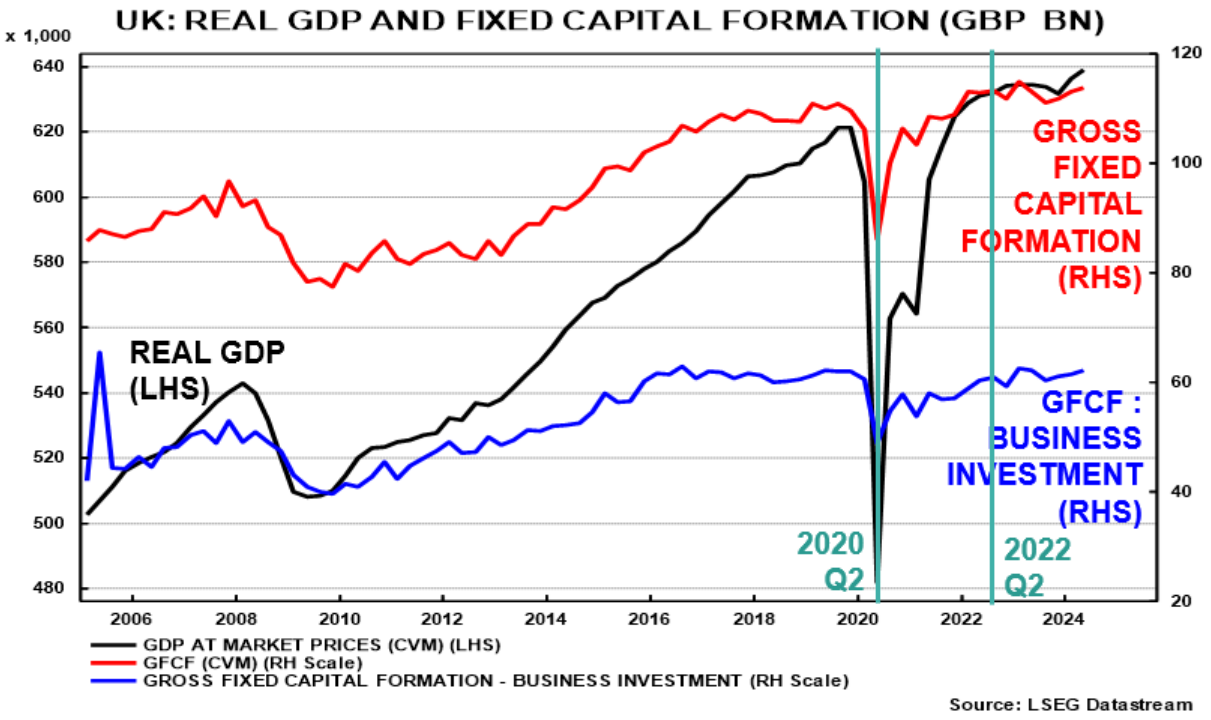


Figure 17. UK Trade Data Reflects the Surge – and Stall – of Money Growth

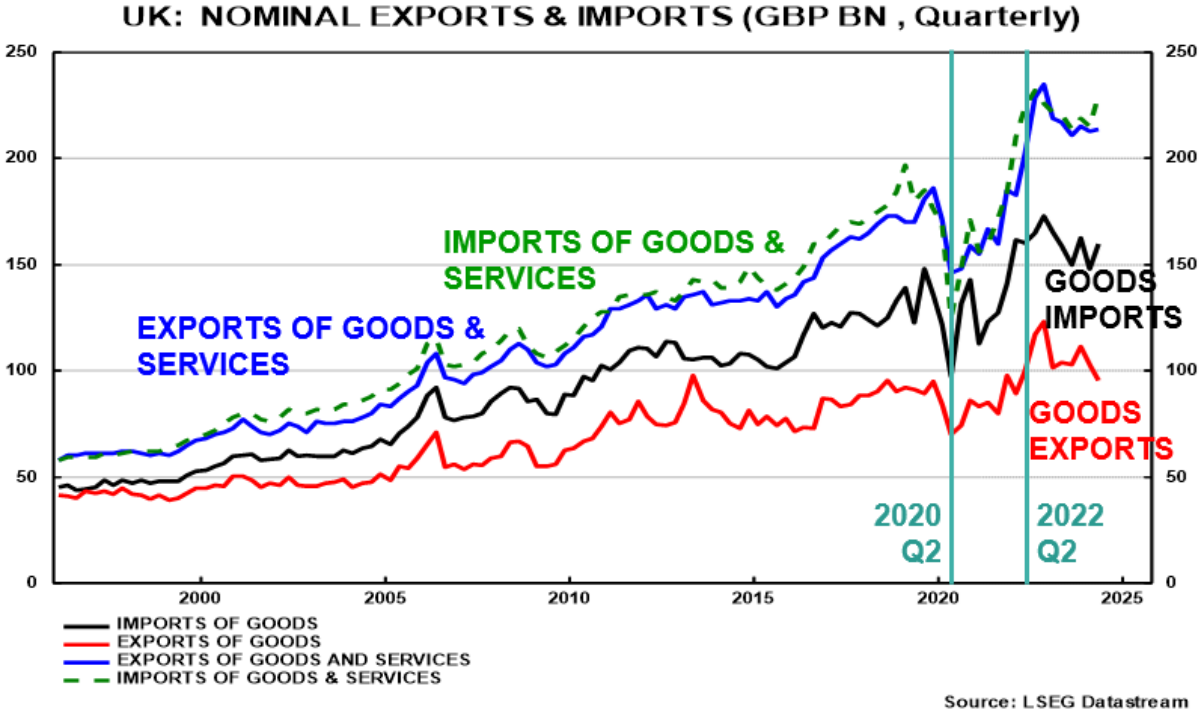
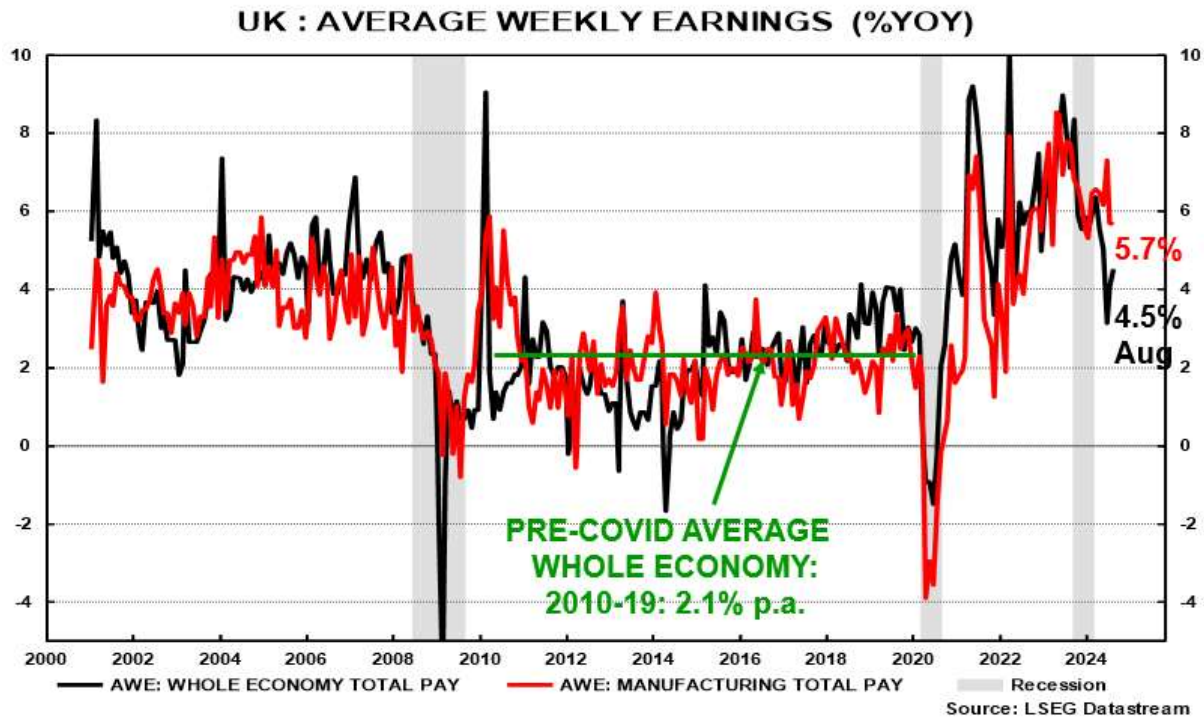


Figure 18 shows how the UK labour market, as measured by the ratio of vacancies to unemployed persons, has returned to its pre-Covid level. The market had been tight in much of 2022 and in the first half of 2023 and therefore, in the view of some analysts, liable to perpetuate inflation via wage increases. Now that normal conditions have returned, that argument is no longer tenable.

Figure 18. UK Labour Market Tightness Eases.

Figure 19. Wage Growth Slowing towards Pre-Covid Rates.



The easing of supply-demand conditions in the labour market is being followed by a slowdown in the rate of wage growth, as shown in Figure 19. After the GFC and before Covid (2010-19) wage rates in the UK increased by an average of 2.1% p.a. Given the slow growth of broad money over the past two years and the lack of any significant change in productivity, it seems highly likely that wage growth will return to close to the pre-Covid rate, though it may take a year or so to reach that rate.

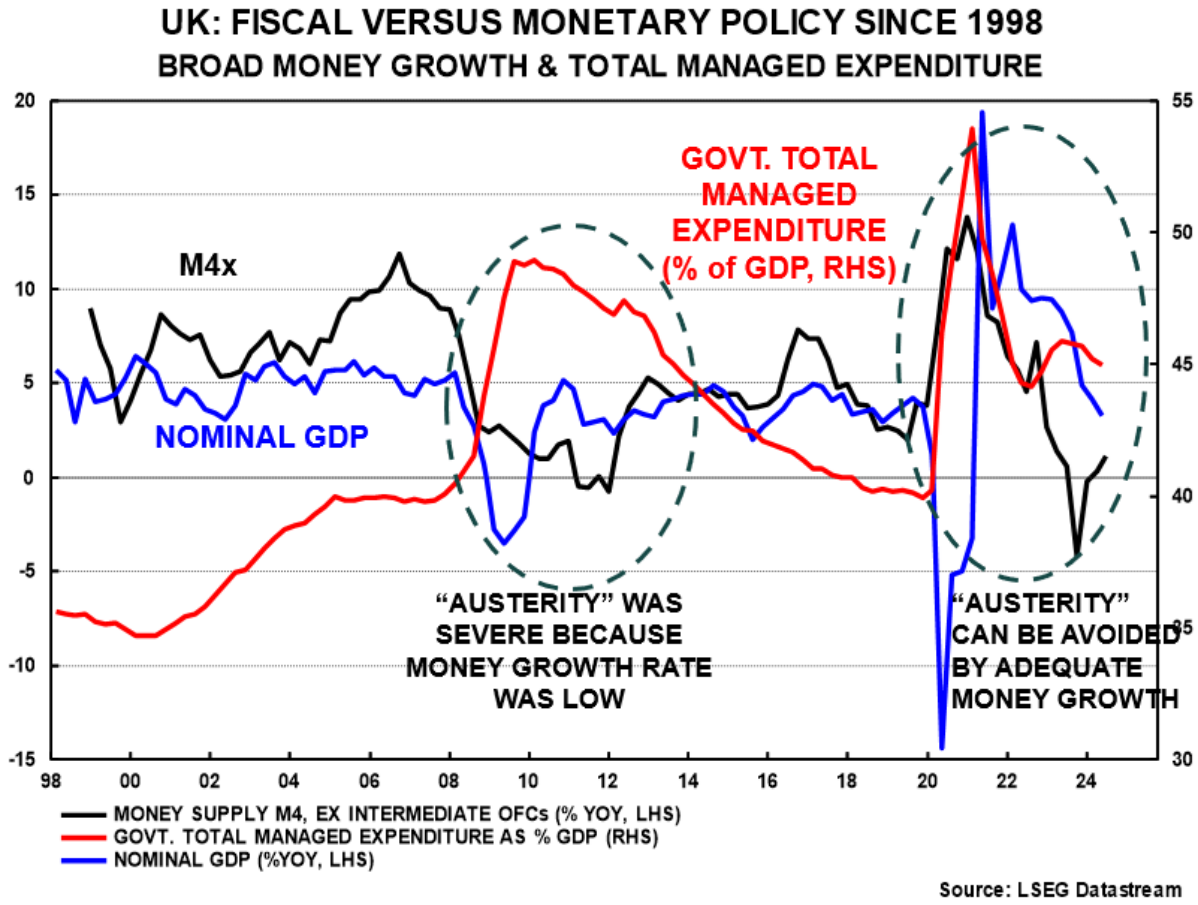
Conclusions

This analysis has argued that slowing money growth and slowing nominal GDP growth in the international arena are likely to be the dominant external influences on the UK over the next 18-24 months. In addition, the slowdown of broad money growth in the UK appears to be translating into the kind of economic slowdown that one would expect from monetary analysis – mainly a slowdown of inflation but also some temporary slowdown in real economic growth following the exuberance of the post-Covid re-opening.

An important topic, especially with a new Labour government now at the helm, is how much growth can be achieved? This will be a key focus of the Budget to be delivered on October 30th.

Speeches from leading figures in the Labour Party promise no return to "austerity", the word they use to characterise the poor UK performance in the wake of the GFC, and especially from 2010 onwards when the Conservative-Liberal Democrat coalition assumed power. It is therefore worthwhile to examine in a little more detail the precise nature of the post-GFC recovery and to consider how any recovery over the next few years may be compared with it.

Figure 20. The Key to Cyclical Recovery is Monetary Conditions, not Fiscal Spending.



Source: LSEG Datastream

Keynesian economists, or "fiscalists", who dominate the consensus in the UK debate on economic policy, typically claim that additional government spending, especially on investment in fixed capital or other favoured items such as education or skills, will boost real GDP growth. Statistically this has always been very hard to prove.

More plausibly, monetary economists argue that an acceleration of broad money growth gives a temporary boost to growth, but if continued only generates inflation as real growth returns to its long-term norm. This was very evident in the Covid episode.

Interestingly, despite a huge boost to fiscal spending after the GFC (shown by the red line in Figure 20), nominal GDP growth (in blue) only bounced back to 5.2% in 2020 Q4, and then slowed again to just 2-3% in 2011-13. Government spending as a share of GDP peaked in 2010 Q1 and subsequently fell consistently as a share of GDP until 2019. This was what Labour call "austerity". In reality, and despite two episodes of QE, slow broad money growth (in black) placed a ceiling on nominal GDP growth through most of the post-GFC years.

Currently the economy again faces a tight monetary environment – in the sense of slow money growth – and an almost certain increase in government expenditure as a share of GDP following the upcoming Budget on October 30. However, the lesson of

the post-GFC years – and the lesson of monetary theory generally – is that the path of nominal and real GDP growth will be far more determined by what has happened to and what will happen to money growth than by what happens to government expenditure.

The key to avoiding a repeat experience of the post-GFC "austerity" is not to boost government expenditure, but to ensure that broad money growth (M4x), instead of averaging just 3.6% p.a. as it did in 2009-19, is consistent with about 4% nominal GDP growth. Allowing for increased money holdings (at just over 1% p.a.), that implies a required money growth rate of about 5% p.a.

Summary and Investment Implications

- The presentation I made at the most recent meeting of the UK Shadow Monetary Policy Committee called for an easing of monetary policy by stepping up monetary growth, ceasing QT, and lowering Bank rate.
- My argument contrasted the consensus framework (which proposes a non-monetary explanation of inflation) and the monetarist framework (which successfully explains the divergent increases in price levels in different countries over the past four years).
- The argument I put forward was that the likely trend in nominal GDP in the international economic system over the next 12-18 months would be dominated by the downswing in monetary growth over the past 18 months.
- Commodity prices, US retail sales, and global trade illustrated the start of these trends.
- Shifting to the UK, I showed that each element of the monetary transmission mechanism was conforming to the monetary framework: the change in money holdings, the movement of asset prices, trends in real and nominal GDP, consumer and capital spending, and UK trade.
- I also showed that the labour market was reverting to its pre-Covid norm.
- Finally, I argued that a repetition of "austerity" – the policy allegedly implemented after 2010 by the Tory government – could only occur if monetary growth was restrictive in the way that it had been in 2010-19.
- My vote, based on the above arguments, was for a further cut of 0.25% in Bank rate and a recommendation to terminate QT, the policy of shrinking the Bank of England's balance sheet by £100 billion between October 2024 and September 2025. The priority should be to ensure M4x growth at 4-6% p.a.
- The investment implications of this environment are that defensive positions should be adopted, especially in UK-based portfolios.
- Although government expenditure is expected to rise somewhat as a share of GDP under the new Labour government, inflation will continue to fall for at least the next two years. This means that gilts should continue to make gains despite the recent sell-off. In the longer run, inflation is the main driver of gilt yields.
- On the equity side, exposure to companies with a large international component in their sales and earnings is the best way to avoid any adverse trends in the domestic UK economy.

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