Put the tools away now, please

The economic and social consequences of the UK's monetary policy regime, and what the government can do about it

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“The task of monetary policy has moved from being a choice…on a single dimension…to a more multi-dimensional choice which involves decisions on which tools to use, and which tools to…have “in the box””

Andrew Bailey, Governor, Bank of England, Speech, 5 February 2021

“There were plenty of losers from the great inflation of 1975. Elderly savers watched aghast as the fruits of their working lives were eaten away. ...pensioners, the self-employed and people who did not belong to unions found themselves tumbling down the economic ladder, their incomes stagnant as prices rocketed… Young and old, rich and poor, nobody was safe from the ravages of inflation”.

Dominic Sandbrook, ‘Seasons in the Sun’, 2012

“Running up bigger debts and printing money that nobody has earned hardly looks the way to stop inflation”

Daily Mirror, editorial, 10 May 1975

1. Introduction: Mission CPI

The Bank of England's monetary policy objectives, set formally by the government in the Bank of England Act (1998) are twofold. First, seek price stability; and second, subject to the first objective, support the government's economic policy (including its objectives for growth and employment). Price stability is defined by the government as a **2% annual rise in the Consumer Price Index (CPI).**

The government instructs the Bank of England ('the Bank') to treat the 2% CPI target as being *symmetrical.* i.e. it's just as bad to undershoot as to overshoot. Members of the Bank's Monetary Policy Committee (MPC) have a sincere focus on this goal, and proclaim themselves to be independent of political influence.

While inflation overshot the 2% target for a period prior to the Global Financial Crisis (GFC) (CPI reached 5% in September 2008), the main concern of MPC members since then has been about *undershooting* the target. In 2020, that concern became extreme – with a negative CPI being considered a distinct possibility. In this context, MPC members have spoken frequently about 'tools' and 'toolkits', as per Andrew Bailey in the introductory quotation to this paper. With interest rates already on the floor – rendering the conventional policy of cutting rates redundant - the Bank has been creative in developing so-called 'unconventional' tools – which could alternatively be described as ***anything to encourage households and businesses to borrow and/or spend more money which, according to prevailing economic theory, will boost prices, growth and employment***. Examples of unconventional tools are 'forward guidance' (where the MPC commits to maintain ultra-easy policy for an extended time period), and 'negative interest rates' (discussed but not yet employed), but by far the most important unconventional tool used to date has been '**quantitative easing'** (QE).

As we shall see, the key driving force of the Bank's decision to employ QE so freely in recent years has been its fear of undershooting its 2% CPI target, but in pursuing this narrow objective it has generated (and ignored, or denied) some very unwelcome side effects – such as the unprecedented increase in public borrowing (outside of wartime). Further, and ironically, its relentless pursuit of this narrow retail price target has made conditions ripe for a sharp and inevitably persistent rise in inflation in the next few years for which the Bank is wholly unprepared, and which will result in a **significant worsening of inequality** in this country. Unless the government **restricts the Bank of England's balance sheet expansion, changes its formal objectives** and, moreover, **brings to bear greater economic common sense on monetary policymaking**, the government's 'levelling up' agenda is likely to fail spectacularly, with dramatic social and political consequences.

2. QE to the rescue

The Bank of England's website describes quantitative easing as "*a tool that central banks, like us, can use to inject money directly into the economy"*. (Perhaps it should be called 'money injection'?). The Bank launched its first modern QE programme in the immediate aftermath of the GFC, buying £75bn worth of UK government bonds (or 'gilts') with digitally-created currency in March 2009. The Bank simply credited the sellers' bank accounts – creating new deposits and thus boosting the broad money supply by £75bn at the touch of a button.

Arguably, at that time, the Bank had little choice but to pump billions into the system in a bid to support asset prices; the high street banks had made risky loans on a scale well beyond anything seen in history and with values collapsing were quite probably insolvent *en masse* – i.e. Barclays, Lloyds, NatWest, *et al.* were about to close their doors. The Bank's QE was pre-approved and underwritten by the government (so much for the MPC's independence) - which also took other radical short-term measures to save the banks. Similar, co-ordinated actions were taken in other countries, most importantly in the US. Asset prices recovered sharply and the banks breathed again. This was the first intervention of this type in the UK since WW2.

If the Bank had stopped QE at that point – and the money that had been created thus far under emergency conditions had been gradually removed from circulation in the following, say, one to two years (as was first intended) – then the potential for disastrous economic and social outcomes that exists today would never have developed. Unfortunately, the Bank did not stop. And so, this is where our tale really starts.

3. Lessons not learned

Although the point of extreme danger had passed, and despite warnings from many observers about the inherent risks of QE, the Bank then proceeded to inject a lot more new money during the course of 2009. By the end of the year, the Bank had created a staggering **£200bn** out of thin air – inflating the nationwide money supply by well over 10%.

What is the problem with magically creating new money? First and foremost, increasing the money supply represents a ***debasement*** of every existing pound in your pocket and mine**.** That's basic economics: suddenly, more pounds are chasing the same quantity of goods & services, thus the purchasing power of each pound is diminished.

Second, the lesson of history is that **once money printing starts, it's difficult to stop: it's just too easy.** This is a lesson we are all about to learn the hard way, by living though a real-life experiment - nothing virtual here (except the money of course). The Bank should have learned this lesson by the end of 2009, as the initial QE total more than doubled. Sadly, it did not.

As we have seen, the early impact of QE **always** appears positive, so that any political or economic argument against it is dismissed out of hand; (much) later, as the printed money works its way deeper into the economy, and as the quantity of new money emitted inevitably accelerates, problems arise which become serious and intractable – **inflation, recession, unemployment, inequality, social conflict and political turmoil. This is where we are heading.**

So why did the Monetary Policy Committee continue to expand its QE programme? From the minutes of the MPC meetings in Q3 and Q4 2009, the key reasons were:

First, members were worried they would undershoot the 2% CPI target if they didn't;

Second, they were not persuaded that the risks of continuing QE were significant *at that time*; and

Third – significantly - because they thought injecting new money into the economy would be good, **based on today's most widely accepted economic theories**, not only for the banks (of this there is no doubt), but for us all. (The Bank's website states: "*The aim of QE is simple: by creating this 'new' money, we aim to boost spending and investment in the economy").* In the Bank's eyes, therefore, QE could be used to meet both its primary objective – 2% inflation – and its secondary objective – higher economic growth – at the same time.

Note that, even as early as the May 2009 MPC meeting, at which the Committee mandated QE of £50bn, there was no longer talk of an acute banking crisis. At the November 2009 meeting (£25bn added), the Minutes stated only that "*the supply of bank credit would probably remain constrained for a protracted period"*. Nevertheless, "*Most Committee members favoured an extension of the asset purchase programme… that would reduce the margin of spare capacity and **bring inflation back to target more quickly than otherwise**…[and]…would support household and business spending…"* (emphasis added).

4. More and more…or less and less? £100 becomes £66

They had crossed the Rubicon. Within just a few months of the GFC ‘near-death experience’, which had undeniably come about in large part from lax monetary policy in all major countries , the Bank of England’s Monetary Policy Committee members were already embarking on a new, contentious, super-easy policy programme, in part simply to raise consumer prices “*more quickly than otherwise”*. Accessing the liquidity fire hydrant once every 50 or 100 years to save the whole British banking system is one thing; using the monetary garden hose to micro-manage the cost of living is quite different. Remember, **if you water your plants too much, they become weak and waterlogged** (and die).

Subsequently, intermittently opening the tap with the primary objective of boosting CPI has become quite a habit for the Bank of England. A repeat of the extraordinary banking collapse of 2008-9 has never been on the cards (even in 2020), but whenever there has been the merest possibility of a marked weakening of the economy, the Bank has re-launched QE – providing ‘stimulus’, but in so doing, debasing the pound yet further and generating myriad other risks and distortions, of which more below in Section 9..

Since 2009, there have been three main occasions of expanded QE: the European crisis of 2011-12 (+£175bn); the Brexit vote of 2016 (+£70bn); and the Covid recession of 2020 (+£450bn). On each occasion, the narrative has been that QE is necessary both to meet the inflation target and to support the economy.

As of May 2021, the Bank has authorised a total of **£895bn** of asset purchases – TWELVE TIMES the original programme – and now representing over one third of UK broad money. **This is the classical economists’ definition of inflation, pure and simple;** if you had £100 in your piggy bank in 2009, today you may still have £100, but its real purchasing power has shrunk to £66. How much will your £100 be worth next year? And the year after? What about in 10 years’ time?

5. QE goes global

Officials at the Bank of England recognise that their frequent use of QE has been a radical departure from previous central banking norms, but show no reluctance to continue – far from it, in, fact. A Bank Staff Working Paper in 2016 entitled "*QE: the story so far*" states matter-of-factly:

"*Significant expansions of central bank balance sheets have been going on for as long as we have had central banks. In previous centuries, however, these monetary injections tended to be associated with the financing of wars or the bail-out of banking systems, rather than operating as a monetary policy tool. … **It is only during this century, and in particular since the global financial crisis, that we have seen central bank balance sheets taking on an explicit monetary policy objective"*** (emphasis added).

Moreover, a recent internal review at the Bank reported that ***"QE has transitioned from being a transient, unconventional crisis response to a persistent part of the monetary policy toolkit".*** *(IEO, 2021).*

The first quote above apprises us that other central banks have made the same quantum leap by adopting QE as a core element of monetary policy. In fact, all the major ones have, and it seems almost coordinated. The Bank of Japan, the US Federal Reserve, the European Central Bank, the People's Bank of China, the Reserve Bank of Australia, the Bank of Canada, and others, have all pursued QE to boost inflation and growth. The Bank of Japan was the first, starting down this road in 2001 but it is the US Federal Reserve (the 'Fed') that has been the undisputed 'champion' of QE; with self-assured certainty, successive Fed Chairmen have convinced the American public over a number of years that injecting 10-digit quantities of new money directly into the financial markets has been economically beneficial (n.b. former Chairman Bernanke even wrote about the "profits" made on these bond purchases – a new level of absurdity in central banking). Since March 2009, the Fed's QE has totalled over $5.5 trillion (over $3 trillion of which came in the past 12 months alone, contributing to a 26% jump in broad money).

Notwithstanding that the Bank of England has plenty of official sector support for its QE programme, the UK's massive monetary emission of the past 12-15 months, when considered in context, highlights not only that the Bank's symmetrical CPI objective is misguided but also that the MPC's QE policy choice has been inappropriate. First, at the onset of the pandemic, UK banks were well prepared to weather a downturn, having strengthened their balance sheets significantly since 2008. Second, the economic disruption caused by Covid related as much to lack of supply as it did to lack of demand – observed most readily today in the market for new and used cars. And third, in the 'worst recession in 300 years', as the Chancellor termed it, wouldn't consumers expect to get a break and at least be able to benefit from lower consumer prices? That the Bank would take such extraordinary and dangerous monetary action just to keep consumer prices up – taking away what is traditionally the only freebie offered to the general population during a recession – seems just plain wrong.

6. The other side of the trade

"QE is not irreversible. To the extent that commercial banks, needing to hold more liquid assets, decide to hold more gilts there is a natural way in which QE will be reversed. The Bank of England would sell gilts to banks and their reserves at the Bank of England would fall."

David Miles, Bank of England MPC Member, Speech, 30/9/2009.

"If [inflation] is not temporary, we know what to do about that."

Sir Dave Ramsden, BoE Dep.Gov., Markets and Banking, Guardian interview, 1/6/21

Though it has already become habitual to today's central bankers, QE is undeniably still a 'new thing'. Members of the Bank's MPC have certainly never previously employed QE, so we must regard today's ongoing QE programme as an experiment. Nevertheless, committee members – in common with other central bankers around the world - seem **surprisingly confident** that they will act in good time to prevent inflationary consequences (and any other bad outcome).

Such confidence is yet more surprising when one considers that **their inexperience of QE is as nothing compared to their inexperience of 'Quantitative tightening', or 'QT'**. Quantitative tightening is the process of removal from the banking system – once the deflationary risk has passed - of the money previously injected, in order to return the money supply back to pre-intervention levels. Central bankers assume they will be able to do this without incident, which is perhaps the main reason why they don't worry about future inflation. If they were able to achieve this, then the pure inflationary bias of QE policy would indeed be fully negated.

The problem is that no modern central bank has yet accomplished it. The Bank of England has not yet once even attempted it. For 12 years and counting, it has been one way for the Bank's balance sheet. **Not a single member of the MPC, past or present, has ever even voted for QT** – even though CPI has jumped above the 2% target on several occasions already (reaching 5% in 2011 and 3% in 2018) and seems certain to soar above it this year. Moreover, there appears to have been very little preparation for such a policy, if a perusal of the Bank's website is a guide: compared to the vast number of speeches, research papers, conference presentations and so on focused on QE, there is an almost total absence of material about QT. One 70-page Staff Working Paper is typical: after a comprehensive investigation of historical and international experience of QE programmes, there is just one line (the last sentence) about QT - *"This leaves to future research important issues such as the impact of a reversal in QE policies and the distributional consequences of QE".* (Haldane, 2016, Ibid)

QT will require the Bank to sell hundreds of billions of gilts back into the market when inflation is rising, possibly sharply, and market participants themselves are also likely to be reducing the size of their bond portfolios. The suggestion that QT will operate as smoothly as suggested by David Miles (above) is optimistic, to say the least. Commercial banks have reserves, it's true, but it is highly unlikely that they will be rushing to buy gilts at today's record-low yields at a time when the Bank is purposefully draining liquidity from the system and, not coincidentally, the government's borrowing demand is at an all-time high.

In investment management, my profession of 35 years, we learn quickly that buying is the easy part. The Bank has certainly become expert at buying, having taken ownership of more than a third of the gilt market! But we would say "***they've only done one side of the trade".*** A policy triumph can only be realistically declared once those gilts have been sold, otherwise the risk remains of high inflation down the road.

7. The wonder that is QE – as claimed by central banks

Before we continue, let's step back and ask a few fundamental questions about modern central banking's most over-employed tool: Does QE even work? And if so, how?

While this paper will argue in the next several sections that QE will lead, in the medium- to long-term, to myriad negative outcomes, the vast majority of written material on the Bank of England's website suggests that QE does indeed 'work', and an uncritical reader would be left in no doubt that QE is an effective 'tool' of monetary policy. For instance:

"*Overall, the papers presented at the conference broadly supported the emerging consensus that QE and other unconventional policies have helped to mitigate the macroeconomic effects of the global financial crisis. … There was evidence that asset purchases and other balance sheet policies resulted in significant effects on the wider economy"* (Joyce, 2012)

"*An asset purchase announcement of 1% of GDP leads to a statistically significant rise of 0.25% and 0.32% in UK real GDP and CPI"* (Weale & Wiedalek, 2016)

A positive outcome from QE is supposedly assured, therefore (according to Bank of England econometricians). But what is the mechanism of QE – i.e. how do the Bank's gilt purchases actually generate "significant effects on the wider economy"? This is the subject of much debate. One MPC member reflected on this uncertainty with the following analogy, not exactly confidence building:

"*…normal monetary policy by interest rate setting is like driving a new Range Rover down the M4: …one knows how long it will take to get to the desired exit; the ride is smooth, well-marked and familiar. …Unconventional monetary policy, including QE, is like making the same trip but: doing so in an urgent hurry; driving a 10 year old used Vauxhall Vectra with a cranky transmission; down a rural road because the M4 is closed; …with all kinds of strange surprises. You will get where you are going using QE, but you are not sure how long it will take to get there, and you will not enjoy the ride."* (Posen, 2009)

The most commonly-quoted 'mechanism of transmission' of QE to the broader economy is termed the 'portfolio balance channel': Bank of England buying pushes up the price of gilts (i.e. drives yields lower), after which the sellers – typically, pension fund managers - are allegedly propelled to take on higher risks (to maintain portfolio yields at the same level as before), thus oiling the wheels for new corporate issuance and investment. However, **at least five additional 'mechanisms'** of QE – which can work concurrently - are suggested:

- the 'signalling effect' (households and businesses think interest rates will stay low for an extended period and thus are more willing to borrow and invest);
- the 'exchange rate' effect (increased supply weakens the pound's exchange rate, making import prices rise);
- the 'liquidity' effect (the Bank's commitment to buy certain lower quality bonds lowers the risk and thus encourages others to buy);
- the 'confidence' effect (people act positively, thinking QE improves the economic outlook);
- and finally, the 'lending' effect (whereby banks lend out the new deposits and the familiar 'money multiplier' operates, expanding lending further) (Haldane, 2016).

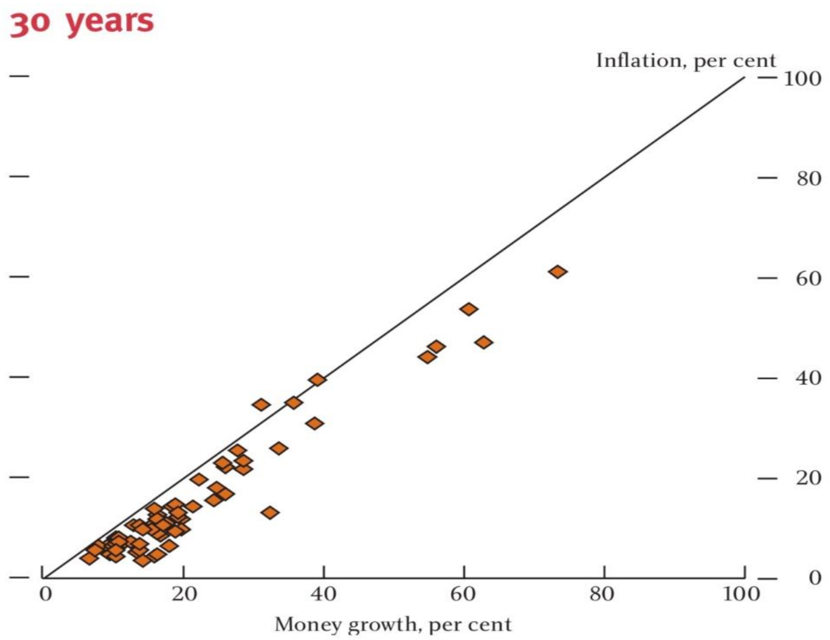
Can newly-printed money really generate such wonderful outcomes? (If so, why don't they just print twice as much, or three times as much? Why set a limit?)

8. Money, inflation and economic growth: another view

Let's apply some common sense. If the primary objective of policy during a particular period is to raise consumer prices, then spraying around new money like confetti (Dennis Healey's word, 1979) will probably do it. Stepping back from such extreme action, it's still very likely an odds-on certainty that if we repeatedly create hundreds of billions of new bank deposits via QE, sooner or later, prices will rise. Such a claim is intuitive and ought not to be controversial and, besides, the economic history books are full of tales of debasement leading to inflation. Mervyn King, when Deputy Governor of the Bank of England, wrote:

"*Few empirical regularities in economics are so well documented as the co-movement of money and inflation. …this relationship is true for broad money as well as the monetary base.*" ("No money, no inflation – the role of money in the economy") (2002)

King backed his statement with this chart, using IMF data, which shows that in the 30-year period 1968-98, the correlation between broad money and inflation was almost 100%:



Researchers at the European Central Bank, similarly, have recognised the relationship:

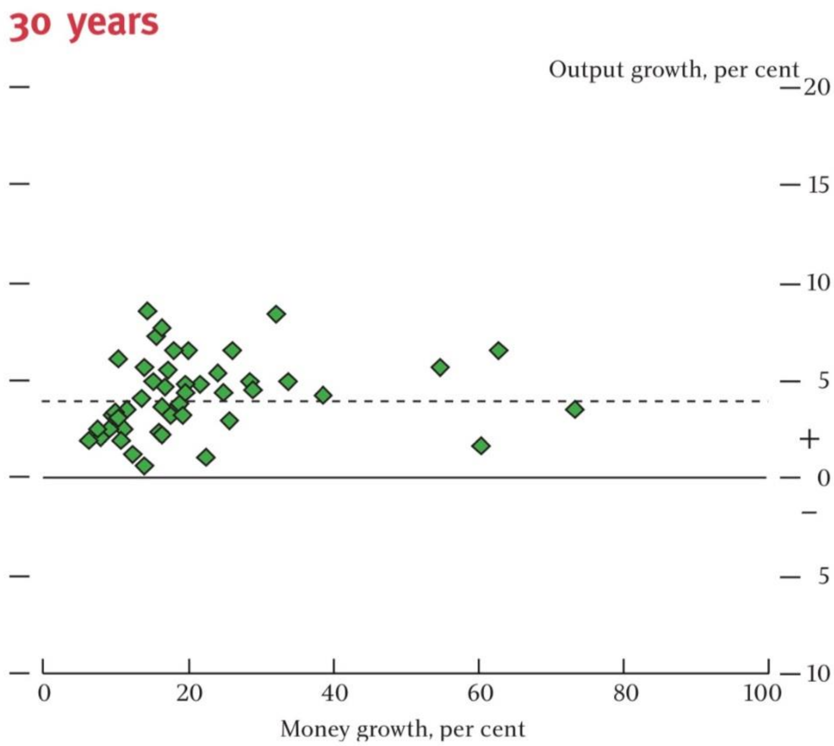
"*From a **medium to longer-term perspective,** inflation moves in line with broad monetary aggregates. This relationship holds through time, as well as across countries and monetary policy regimes**: it is "hardwired" into the deep structure of the economy."*** (ECB Monthly Bulletin, May 2012) (emphasis added).

Note that the ECB's important qualification regarding the timeframe was also recognised by King:

"…the correlation between money growth and inflation is greater the longer is the time horizon over which both are measured. In the short-run, the correlation between monetary growth and inflation is much less apparent". (King, Ibid.)

Now let's consider the historical long-term relationship between money supply and economic growth. Unfortunately, the data presented by King does not support the claim that QE boosts the economy:

"The other side of the coin to this close relationship between money and prices is the absence of a long-run relationship between money and output growth". (King, Ibid.)



The correlation between broad money and output growth was *de minimis* (- 8%). Is this really a big surprise? The injection of monetary rocket fuel may well get the economic aircraft off the ground, but then what? The data reinforces the conclusion from Friedman & Schwartz's comprehensive, scholarly and highly influential work 'A Monetary History of the United States, 1867-1960':*"You cannot permanently enrich a country, or raise real wages, simply by easing monetary policy and engineering some inflation".*

So let's, therefore, make two revisions to the central bank-promoted beliefs about QE:

First, observed short-term impacts of QE on prices should be considered unreliable and by no means indicative of the magnitude of the longer-term inflationary consequences. In other words, **the fact that we haven't seen high inflation from QE to date does not mean that it will not occur; in fact, it remains highly likely**.

Second, while there may be evidence that QE supports the economy in the short-term, **historic data casts considerable doubt on the suggestion that it will support the economy in the long-term.**

9. The QE trick

"*Everyone loves an early inflation. The effects at the beginning of inflation are all good. There is steepened money expansion, rising government spending, increased government budget deficits, booming stock markets, and spectacular prosperity, all in the midst of temporary stable prices. Everyone benefits, and no one pays. That is the early part of the cycle".*

(Jens Parsson, 'The Dying of Money', 1974)

If QE doesn't exactly do what the Bank of England claims it does, what does it do? Answer: **it tricks us**. A predictable cycle is set in motion. At first, it's a boon – the government borrows at lower interest rates, financial market liquidity improves, companies can roll over debts more easily, bank balance sheets improve, the stock market rises, investors feel wealthier, bills and wages are paid as usual, property prices (highly sensitive to interest rates) improve, and so on. And, for quite a long time, consumer prices remain steady.

With interest rates near zero and likely to stay there, financial market players jump on the trend of rising asset prices. The cheap cost of borrowing and the absence of fear of official rate hikes encourages leveraged risk-taking in all markets – equities, corporate bonds, currencies, junk bonds; it's hedge fund heaven, a speculator's paradise. Financial asset prices are driven up further.

Banks and corporations participate too – bigtime. Extremely low interest rates encourage corporate managers to borrow heavily for share buy-backs, and entrepreneurs to start new ventures. Households stretch mortgages to the limit. Banks compete aggressively for clients, seeking to employ surging new deposits. Business is brisk. For a time.

But then the central bank inevitably stops or pauses QE – or "tapers", using current jargon. When the monetary surge ends, the good times continue for a while but the impetus for further stock and bond market gains dissipates. The liquidity injection has pushed up valuations and boosted business activity to an artificial level which is inappropriate given the real foundations. When a trigger event occurs – say, an unexpected election (or referendum) result - stock markets drop, often precipitously, raising fears of another recession. Leveraged players pull back sharply, market liquidity deteriorates and the 'wealth effect' goes into reverse; the central bank gets concerned again about deflation and, once the economic data confirms the slowdown, leftist commentators and investment bank economists join in a loud chorus for more 'stimulus'. The central bank revises down its growth and inflation forecasts, justifying the restart of QE; the government concurrently announces new fiscal measures, easily financed via bond issuance at record-low interest rates – and mostly bought by the central bank.

And so the cycle repeats.

The central bank does not realise (and neither does the government) that it is now on a **treadmill.** Stop the printing, financial assets plunge, recession follows. Print more, financial assets and business activity become even further divorced from reality.

The central bank inevitably announces more QE because it believes the 'stimulus' supports growth. But to make the same impact, QE needs to be bigger each time. (It's just maths: in the UK, to inject 13% of GDP 'stimulus' into the economy in 2009 required £200bn, but today it would require £270bn). The government finds it so easy to borrow, it continues to do so in unprecedented amounts.

Note that, to this point, QE is a particular boon to those who own a lot of stocks and bonds (the wealthy) and to those who need to borrow a lot. The biggest UK borrower is the government. Most of the population are oblivious to what is happening, but some get lucky speculating with cheap money on second homes, tech stocks or cryptocurrencies.

As the amount of money printing and concomitant government borrowing soars yet further, some people start to get concerned about (a) asset 'bubbles'; (b) the government's ability to pay its debts; (c) blurring of the boundary between monetary and fiscal policy; and (d) future inflation. The writing is on the wall for many as they realise that **that which cannot go on for ever, will not,** but the central bank denies there is any issue (n.b. MPC members have done so repeatedly).

Central bankers commonly claim either that asset bubbles cannot be identified prior to their bursting, or that valuations are not especially high, or that markets are driven by other factors. *Or they don't include the bond market in their assessment:* at the end of 2020, approximately $17 TRILLION of marketable bonds globally were trading with NEGATIVE yields. Bond valuations are now completely divorced from reality; inflation is surging while government credit quality is deteriorating fast. Could it be something to do with c.$15 trillion of global QE bond purchases since 2008?.

Eventually, many more people start preparing for inflation by buying 'real' or 'hard' assets, such as gold, silver, copper and other commodities (and agricultural land, art, antiques, classic cars, etc) and equity in companies that produce them, such as mining stocks. Bond yields start to move higher.

While the central bank continues to downplay the risk of consumer price inflation (having ignored completely the inflation of financial assets - especially bonds -where the 'latent' inflation is now stored), the redirection of flows into commodities drives producer prices higher and higher:

"*Commodities rose to their highest in almost eight years amid booming investor appetite for everything from oil to corn. Hedge funds have piled into what's become the biggest bullish wager on the asset class in at least a decade, a collective bet that government stimulus plus near-zero interest rates will fuel demand [and] generate inflation…as the economy rebounds from the pandemic. The Bloomberg Commodity Spot Index, which tracks price movements of 23 raw materials, rose to its highest since March 2013 [and] has gained more than 60% since March 2020."* (Bloomberg 23/2/21)

Consumer price inflation is now baked into the cake; owners of inflated financial assets will increasingly switch into hard assets in an attempt to maintain real wealth. **Everyone else – especially those on fixed wages/pensions – will suffer badly as consumer prices surge.**

Once inflation sets in, it persists. People change their behaviour to cope with it, in a way that reinforces and prolongs it (as we saw in the UK in the 1970's), or worse, magnifies it, as we saw around the world in the many episodes of hyperinflation of the 1920's (eg Germany, Poland), 1940's (eg Greece, China), and 1990's (eg Argentina, Brazil). The realities of inflation:

- Companies raise prices and retailers follow;
- workers demand high wage increases;
- 'indexation' becomes prevalent;
- everybody builds inventories to protect from future price hikes;
- banks raise interest rates and reduce lending;
- the economy suffers and unemployment rises;
- strikes and social conflict ensue.

Nothing about inflation is 'transitory', except perhaps the government in power. The negative consequences of high inflation for both our standard of living and for inequality are well known. **'Levelling up' in this environment is a fantasy.**

10. Monetary policy without money

What elements of today's *unsound* monetary policy regime need to be reformed so that we can get off this destructive economic rollercoaster?

One place to start would be to assess the economic foundations of contemporary inflation forecasting at the Bank of England. Given that inflation can be expected to follow monetary growth (albeit with a long lag), to forecast inflation we would expect the Bank's economists to pay close attention to monetary statistics. And fortunately, the Bank of England's website publishes much of the monetary data that is required. Surprisingly, however, the most recent MPC Minutes (May 2021) show a complete absence of discussion about the money supply, either domestic or international - even in the specific section headed "Monetary and financial conditions". The lack of focus on the money supply itself is evident when one surveys recent research papers and speeches - and it is a similar story at other major central banks. Monetary data just doesn't seem to be considered relevant by central bankers these days. Why ever not?

The most likely reason is that money supply plays no role whatsoever in neo-Keynesian economic theory, to which almost all modern economists subscribe – thus contemporary macroeconomic models exclude money as an input. Jerome Powell, Chairman of the US Federal Reserve, even made this extraordinary statement recently:

"*You know, there was a time when monetary aggregates were important determinants of inflation, [but] that has not been the case for a long time".* (US House Fin. Serv. Cttee hearing, 24/2/21)

Following the same dictum, members of the MPC, certainly in the recent past, have not paid much attention to monetary data when making inflation forecasts. Money is mentioned, ironically, only in the context of the **quantity of QE t**hat is to be authorised! From reading the Minutes, the principal factors in inflation forecasting for the MPC appear to be: first and undoubtedly foremost, the expected economic growth rate; and second, the amount of 'spare capacity' in the economy – including the rate of unemployment.

Note that ***this is certainly not about to change***, as the only member of the MPC who appeared to consider monetary data as important has now left the Bank. (In a recent, excellent speech, departing Chief Economist Andy Haldane contrasted the trajectory of UK broad money in the past 12 months during the pandemic with its trajectory in 2008-9 during the GFC). (*Inflation: A Tiger by the Tail*, Online Speech, 26/2/21)

Accurate macroeconomic forecasting is undoubtedly a most challenging task. But as we have learned above, and following the assertion of Milton Friedman that "*inflation is everywhere and at all times a monetary phenomenon",* the contemporary economist's focus on economic growth as the prime driver of the inflation rate appears to be tragically misplaced. We know this from the 1970's 'stagflation', when inflation and recession co-existed, and from the 'golden era' of the nineteenth century, when the British economy grew at double-digit rates for many decades without significant consumer price volatility. In contrast, there is strong evidence that forecasts of inflation *in the medium to long-term* can be guided usefully by a study of monetary data. At a minimum, therefore, **the government should plan to build an enhanced appreciation for monetary economics at leading universities as well as at the Bank of England.**

11. New Mission: Sound Money

The MPC minutes of November, 2009, at the time of the announcement of a further £25bn of QE, included the immortal line "*A number of Committee members noted that one consequence of additional asset purchases would be to* ***bring forward the point at which the extraordinary degree of stimulus could begin to be withdrawn****, if the projected impact was realised"*. Is this not like a parent giving a child another bag of sweets and saying "Well, once he's eaten those, he won't want any more"? £695bn of 'stimulus' later, the answer is clear.

When high inflation burst forth in the UK in the early 1970s, the government responded at first by trying to fix prices, a policy that quickly failed and was abandoned. Successive governments have attempted to solve monetary policy questions by fixing something else. In the late 1970s and early 1980s, it was monetary aggregates, and in the early 1990s the pound was fixed in the ERM. Since 1998, there has been a fixation on a 2% p.a. target for consumer prices. Meet the target and all will be well, is the claim.

Evidently, all is not well. It is 2021, but it feels like 1971. The Bank of England, in convoy with all other major central banks, and most contemporary economists, has travelled "*in a hurry...down a rural road…with all kinds of strange surprises"*, but has failed to notice the "INFLATION AHEAD" signs. Money itself – the central banker's *raison d'etre,* appears to be the global blind spot; it is not considered important any more, yet the solution to every problem – whatever the cause - is plenty more of it. Examination of the unintended consequences of QE is resisted.

The Reserve Bank of Australia, in late February, started employing QE to purchase long-term government bonds *simply to stop yields from rising*, at a time when primary commodities (the country's most important economic products) were soaring in price. In other words, the RBA is now fixing the price of long-term money as well as the price of short-term money. The Financial Times reported that *'Other central banks may come under pressure to follow the RBA'.* Pressure from whom? Who thinks fixing the price of the economy's most important commodity of all – money – is really a smart idea? Hopefully, not the Bank of England! Is it any wonder that bond investors are starting to demand higher yields? Is printing more money really going to change their minds?

The Bank of England is certainly facing a challenge, and not entirely of its own making, clearly. Financial institutions in the UK and elsewhere have, over a period of several decades, become accustomed to the US Federal Reserve, in particular, operating with a 'structurally' easy monetary policy bias (for fear of deflation), and then playing the role of the cavalry coming to the rescue whenever the economy has weakened. The ECB, Bank of Japan and others have all played along. The solution, however, is certainly within the Bank's grasp, if the government will direct it properly.

The trillions of QE that have been pumped into financial markets by global central banks now represent latent inflation that, sooner or later, when consumer inflation expectations rise more broadly, will be unleashed. As in the 1970's, the price explosion will be global and could also be shocking and unremitting. Here in the UK, the tools in the Bank of England's toolbox will likely prove feeble against this powerful price invasion.

To hold back the inflationary waves – so that we can first, protect the less well-off, then maximise the prosperity of 'Global Britain' this decade and in the future – the government needs to take urgent, radical action:

- **(i)** **The Bank of England needs to be directed to break free from modern macroeconomic 'groupthink'.** There needs to be recognition of the key inadequacies of neo-Keynesian economics and more exposure to 'Austrian' economics (eg by the appointment of Austrian school economists to the MPC). In particular, it must be understood that significant official sector intervention in either the price or quantity of money for long periods will badly affect economic outcomes.
- **(ii)** The idea of out-and-out consumption, promoted by central banks as a panacea, needs to be downplayed while **the value of saving, which has been systematically denigrated, needs to be restored and promoted**. The idea that monetary 'stimulus' raises economic growth should be discarded and deflation paranoia must go (lower prices for goods and services are *just fine* with consumers).
- **(iii)** Crucially, **the government needs to change the Bank's monetary policy objective**. The Bank's **balance sheet should be tightly constrained** (i.e. no more QE!) and the symmetrical 2% CPI target should be replaced with the objective of **promoting and maintaining *sound money* in the long-term – i.e. a currency that maintains its *real purchasing power* from one generation to the next.**

All it will take to start the ball rolling is political courage by this government to re-write the Bank of England Act. Only with sound money will households and businesses – domestic and international - know that if they earn a pound, spend a pound, invest a pound or save a pound, a pound is what it will be, this year, next year and the year after that. Who will offer an opinion on what that would mean for economic confidence? I say, investment in the UK would boom. **But most importantly, the possibility of runaway inflation that impoverishes the majority of the population will be eliminated.**

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