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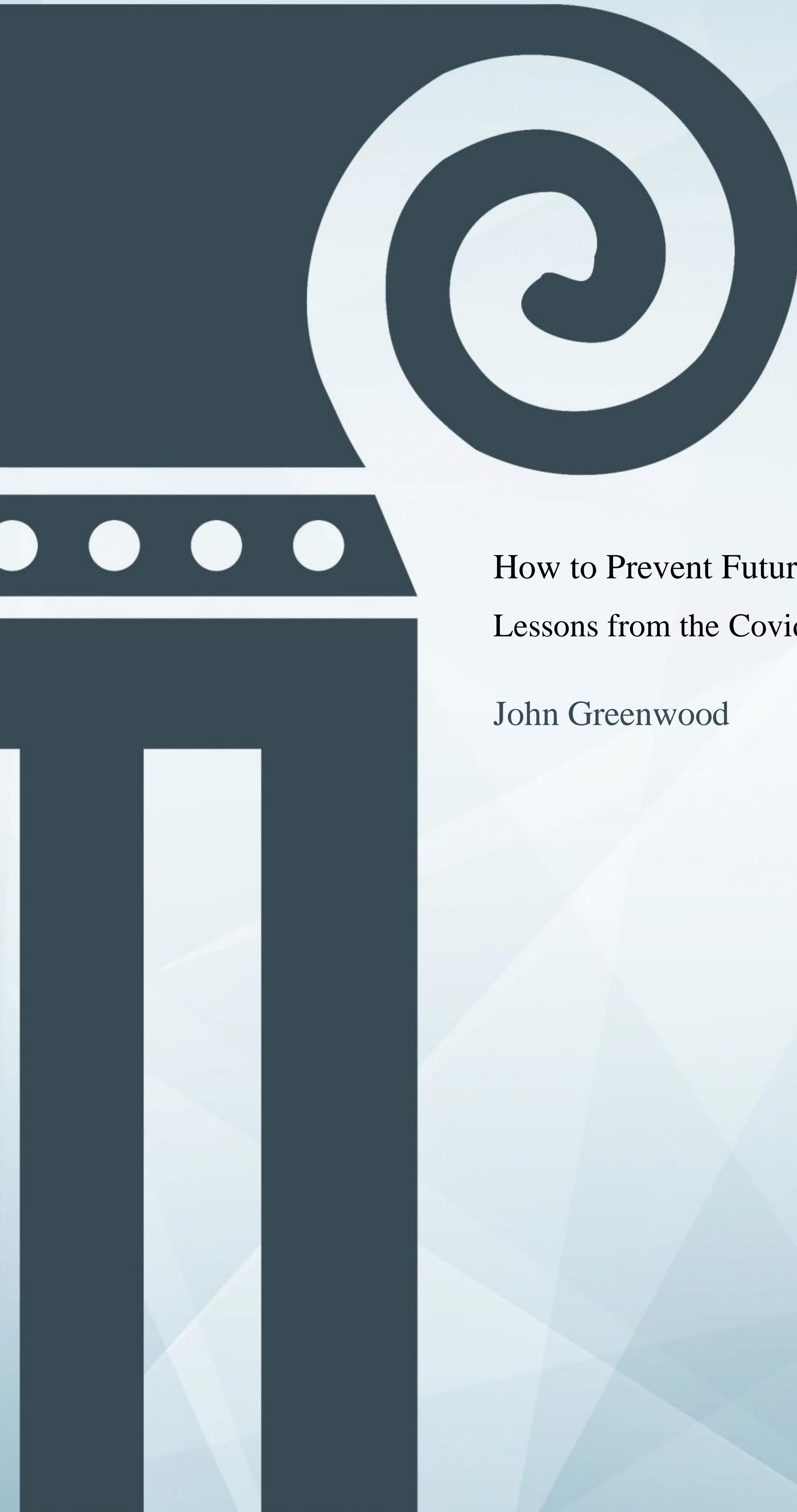

How to Prevent Future Inflation. Lessons from the Covid Inflation

John Greenwood

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First published in 2023 by
Politeia
55 Tufton Street, London SW1P 3QL

E-mail: secretary@politeia.co.uk Website: www.politeia.co.uk

ISBN: 978-1-7392079-3-9

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Cover design by Sonia Pagnier

POLITEIA

2023

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How to Prevent Future Inflation – Lessons from the Covid Inflation

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Introduction

The Bank of England has been under fire for its incorrect inflation forecasting. But more importantly, the Bank, along with other central banks, also made serious errors in policy implementation during the Covid pandemic. Recently, the House of Lords Economic Affairs Committee pin-pointed both problems in its report of November 2023, saying "the persistence of above-target inflation over this period also reflects errors in the conduct of monetary policy." In addition, the Committee warned that the Bank must 'be more pro-active in encouraging a diversity of views' including in appointments to the Monetary Policy Committee.[1] But the Committee also drew attention to the role of the Treasury.

What role should the Chancellor of the Exchequer and the Treasury play in inflation control and what lessons should the country's political leaders now learn?

The Outlook - The government's approach

The declarations about inflation by Chancellor of the Exchequer Jeremy Hunt and by HM Treasury in the Autumn Statement may have seemed at the time to be good politics, but, notwithstanding the OBR's blessing, the underlying economics were highly questionable.
From the government's side we had:

- "The government must continue to bear down on inflation, and the Office for Budget Responsibility (OBR) forecasts that government policies in the Autumn Statement will reduce inflation next year."
- "Reducing debt and borrowing is essential to controlling inflation."
- "Inflation is less than half its peak. Responsible decisions taken by the government to limit borrowing have supported the Bank of England in its action to bring inflation down."
- "With inflation falling and the economy and public finances stabilised after a series of unprecedented shocks, the government can now take the long-term decisions necessary to strengthen the economy and build a brighter future."

Together these statements and other similar expressions by senior government officials suggested that (A) the government had some degree of control over inflation and had played a part in reducing it, (B) the debt level was relevant to inflation, and (C) the outlook had improved after a rocky period that resulted from a series of external shocks.

Unfortunately for the Tory party and its leadership, every one of these propositions is dubious at best, and in some cases demonstrably false.

Similarly, the OBR's inflation outlook is highly questionable, based as it is on a methodology that, like the Bank of England's, omits inflation's ultimate source. In the OBR's 170-page "Economic

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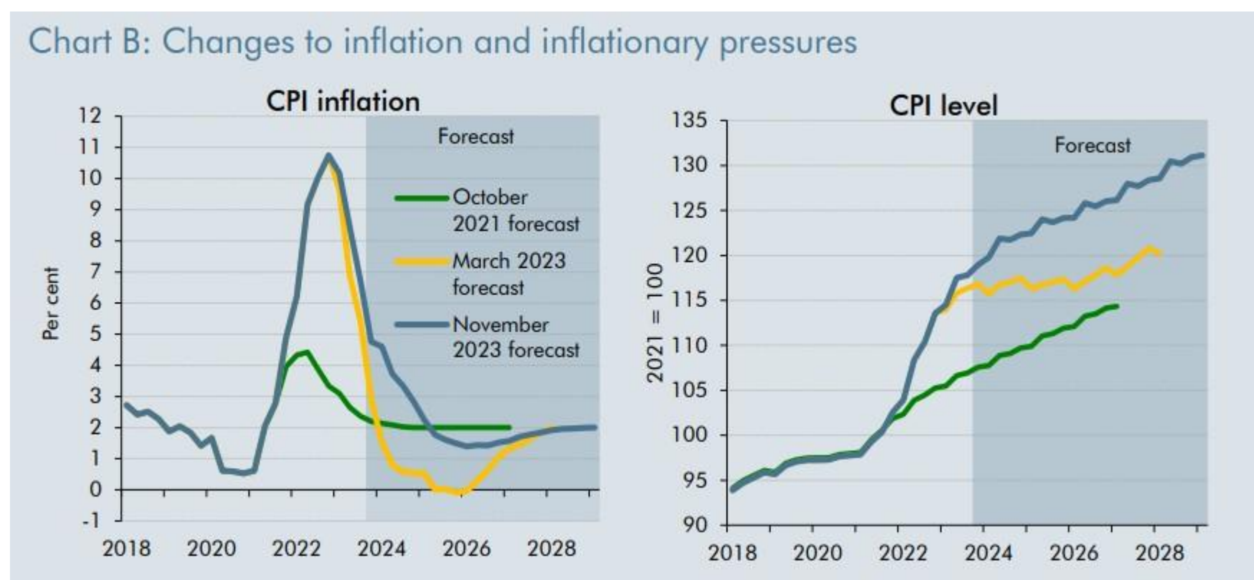
[1] *Making an Independent Bank of England Work Better*, Economic Affairs Committee, House of Lords., November 2023,. https://publications.parliament.uk/pa/ld5804/ldselect/ldeconaf/10/1002.htm)

and fiscal outlook", inflation is mentioned 253 times; but money, the money supply, and M4x are not mentioned even once!

- Instead, the OBR's report had key sections (pp. 18-26 including Box 2.2, "The source of inflation and its fiscal consequences") which concentrated on the demand-side and supply-side impacts of the government's fiscal measures, with a degree of "output gapology" thrown in.
- But the factors that commanded the OBR's attention – energy prices, second-round effects, and economic slack -- are all coincident or lagging indicators of a transmission process that was well under way before the Russian invasion of Ukraine.
- Essentially, the OBR was reporting how the transmission of inflation was working itself out among different sectors of the economy and claiming that these factors (food, energy, tradables, non-tradables, etc.in their Chart 2.4) were the drivers or "sources" of inflation. They are not.

To drive the point home, consider the OBR's Chart B in Box 2.2 (p. 25). The chart (reproduced below) shows how, as late as October 2021 the OBR – along with the Bank of England, it should be said – was forecasting inflation to be a temporary or "transitory" blip and that it would soon return to the 2% target (see the green line). Even in March 2023 they forecast a steep fall, largely reversing much of the previous surge in inflation by falling below the green line and converging back towards 2% from zero in 2026 (observe the yellow line). The latest forecast (in blue) shows inflation falling later than previously thought, declining temporarily below 2% but converging on 2% in 2027 ("averaging between 2024 and 2028", p.24).



The Outlook – A monetarist's response

As a monetary economist my reaction has been one of The government, the Bank and the OBR have all made mistakes which were entirely avoidable if they had just done one thing: paid attention to the rate of growth of money, specifically M4x. What ***has*** happened to the OBR's blue line was predictable, and their forecast would be substantially improved if they took into account recent trends in money growth.

Table 1. Every Episode of Inflation in the UK has been Preceded by Rapid Money Growth

PM/Chancellor or BOE Governor & events	Dates for Money Growth	M4 Growth Rate (quarterly data; average % change over previous year)	RPI (Retail Price Index, average % annual change, starting one year later, and ending one year later than M4 growth)	RPI (Retail Price Index, average % annual change, starting two years later and ending two years later than M4 growth)
Alec Douglas-Home & Reginald Maudling, then Harold Wilson	**1964 Q1 to 1967 Q2**	8.4%	3.7%	4.0%
Harold Wilson; Pound devalued	**1967 Q3 to 1968 Q3**	11.4%	5.6%	5.6%
Harold Wilson	**1968 Q4 to 1970 Q4**	7.5%	7.6%	8.2%
Edward Heath & Anthony Barber; 1st Oil Crisis	**1971 Q1 to 1973 Q4**	19.5%	10.8%	16.4%
Jim Callaghan, then Margaret Thatcher	**1978 Q1 to 1982 Q4**	16.2%	11.3%	9.6%
Margaret Thatcher & Nigel Lawson; 2nd Oil Crisis	**1986 Q1 to 1990 Q4**	16.5%	6.4%	6.4%
Gov. Andrew Bailey	**2020 Q1 to 2021Q4**	9.3%	7.8%	10.8%

The truth is that every episode of sustained and substantial inflation in the UK has been preceded by a surge in money growth, and that is exactly what happened in 2020-2021 (Table 1), though fortunately the money growth was not as egregious in 2020-21 as successive British governments had presided over in the 1970s and 1980s.

At this point it is worthwhile to digress to focus on the two oil crises of 1973-74 and 1979-80. Most people wrongly attribute those inflations to the oil price hikes. As the table clearly implies, the prior double digit increase in money was the reason for those episodes of inflation, not the oil shocks themselves. The same applies to 2022: if there had been no prior surge in money growth in 2020-21, energy prices might have risen, but overall inflation would have been restrained (as was the case in both Switzerland and China which did not allow prior surges in money growth).

Note in Table 1 how long the lag is between the surges in money growth (column 3) and the impact on inflation -- typically at least one year (column 4) or two years (column 5). This is why it is superficial for the OBR or the Bank to talk about energy prices or food prices driving up inflation, and meaningless to talk about controlling "second round effects" or "managing expectations." If these were important in controlling inflation, why does the rate of money growth as much as two years earlier have such a strong and consistent impact?

Conversely, every episode of relative calm on the inflationary front has been associated with lengthy periods of low and stable money growth (Table 2).

Table 2. Periods of Low Inflation have been Preceded or Accompanied by Low and Stable Money Growth.

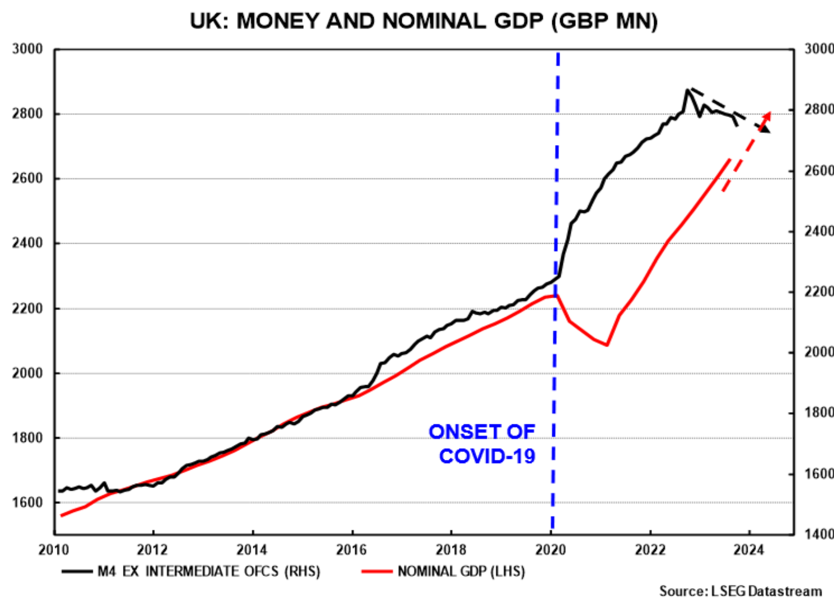
All data shown as % year-on-year changes	**Average Money Growth**	**Av Nominal GDP Growth**	**Peak Inflation Rate**	**Average Inflation Rate**
The Great Moderation	**M4 +7.0% p.a. 1991-2006**	5.0% p.a. 1992-2007	RPI 4.8% March 2007*	CPI 1.9% p.a. 1992-2006
Post-GFC Recovery	**M4x +4.5% p.a. 2013-2019**	2.5% p.a. 2014-2020	CPI 3.1% RPI 4.1% Nov 2017**	CPI 1.4% RPI 2.5% 2014-2020

*Another high for the RPI during the Great Moderation was 4.2% in May 1998.
**An additional high for the CPI during the immediate post-GFC period was 5.2% in September 2011 after the pound fell from over $2.00 in the first half of 2008 to around $1.40~1.45 in 2009-10.

Surely the lesson is obvious. If we want to know what is going to happen to inflation, we must check out what has been happening to money growth. This can be done in a number of ways, but here I have chosen just two.

First, let us look at the *level* or supply of money and its relation to spending or nominal GDP in the following chart.

Chart 1. Spending follows money.



Before the onset of Covid, money (in black) and spending (or nominal GDP in red) were tracking each other, growing at similar, mid-single digit rates (4-7% p.a.). This was what gave us low and stable inflation through much of the post-GFC period. But when Covid struck, the economy was abruptly shut down, and the Bank of England created a huge amount of additional money by buying gilts in the open market and making corresponding payments of new money to the sellers, pumping up the money supply. We know from Tables 1 & 2 that it takes up to two years for money growth to be reflected in inflation (the nominal part of nominal GDP), so it was natural that spending (including inflation) in Chart 1 should eventually catch up to M4x.

There are two observations to be made.

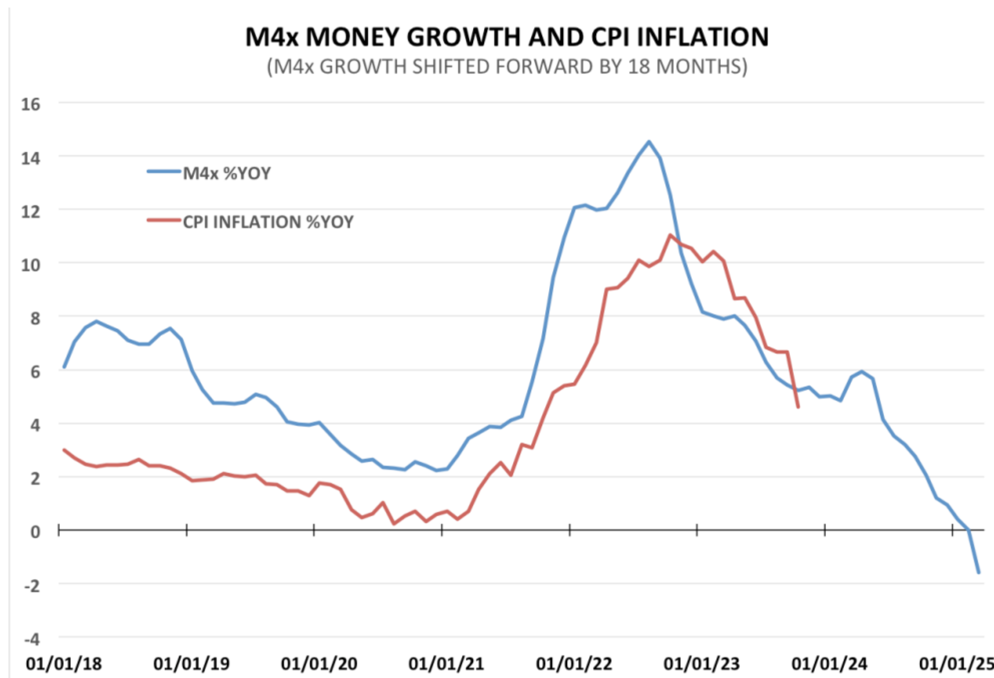
(1) Compare the shape of M4x in the chart above with the actual inflation recorded in the right-hand panel of the OBR's chart B. The similarity is not a fluke. Tables 1 & 2 tell us that inflation follows money growth. It is therefore bizarre that nowhere in all their ponderous analysis do the OBR boffins even mention money. And their analysis of the "sources" of inflation is nothing more than a description of how the transmission process (goods prices rising first, service prices and wages catching up later) is operating. Any monetary economist could have told you – as we did https://www.ft.com/content/c2d1ffe6-e1b9-48cb-ab49-1633e41ce857 – in 2020 what was going to happen to inflation in 2022 or 2023. But the Bank and the OBR have been in persistent denial.

(2) The re-convergence of M4x and nominal GDP is going to occur very soon. It has been brought forward by the sharp downturn in the level of M4x (dashed black arrow in Chart 1) resulting directly from the Bank's decision to conduct QT (disposal of its gilt portfolio) at the rapid pace of £80 billion in the year to September 2023, recently raised to £100 billion for the year to September 2024 economy and then inflation as soon as the excess money balances created in 2020-22 have

been run down. This means that the inflation process will come to a stop very quickly in 2024 and threaten deflation in 2025 if the monetary contraction continues.

This is why the OBR forecast is so out of touch with what is really behind the decline of inflation.

Chart 2. Inflation follows money growth with a lag of about 18 months.



Second, let us look at what happened to the ***growth*** of money as a result of Governor Andrew Bailey's decision in early 2020 to "Go big", i.e., to conduct asset purchases (QE) on a very large scale. After all, he must have mused, since QE did not create inflation after the GFC, it would not do so in 2020 or 2021. But contrary to what happened a decade earlier (when broad money did not grow much beyond a subdued growth rate on account of the weakened condition of the banks in the early 2010s), this time the banks were in good shape and the result was an explosion in money growth – faster than anything since the Lawson boom of the late 1980s. In Chart 2, money growth has been shifted forwards by 18 months – a compromise between the 1-year and 2-year lags shown in Table 1 – to show the likely path of inflation over the next year or so.

On this simple basis, inflation is clearly going to fall well below target in 2024, and we may even have deflation in 2025 – a very different view from that expressed by either the OBR or the Bank of England. Having pushed too hard on the accelerator during Covid, the Bank is now pushing too hard on the brake post-Covid.

Monetary contractions are very rare, but when they do occur, they invariably lead first to recession and then to deflation. For the government and the Tory party, the implications of the current monetary outlook could hardly be worse.

Stronger Action by the Chancellor, Stricter Accountability to Parliament

In its conclusions to the report (p.1 above) the House of Lords Economic Affairs Committee commented that:

> *There is a notable absence of any detailed discussions about money supply in the Bank's published Monetary Policy Reports. We recommend that the Monetary Policy Reports should include discussion of the main monetary aggregates, accompanied by an analysis of their relevance to the Bank's inflation outlook and the various scenarios the Monetary Policy Committee considers. This would ensure adequate transparency in how the Bank approaches its monetary policy decision-making.* (Paragraph 122)

But given the evidence a far tougher course is indicated. The dismal record of the past four years suggests that stronger action by both HM Treasury and Parliament, is needed, first to reshape the Bank's mandate to avoid the errors of the recent past, and second to ensure better governance and accountability in future.

With respect to the Bank's remit, it is clearly not enough simply to set the inflation target and allow the Bank full discretion as to how to achieve the target. Nor is it enough to require the Bank, in the words of the House of Lords Economic Affairs Committee to *'include discussion of the main monetary aggregates, accompanied by an analysis of their relevance to the Bank's inflation outlook...*'. What we have learned from the Covid inflation episode and what the tables above demonstrate beyond any doubt is that moderate rates of broad money growth (M4x nowadays) are a ***sine qua non*** for meeting the inflation target. The Chancellor's mandate to the Bank should therefore specify the inflation target ***and*** a limited range for annual broad money growth.

On the governance and accountability side, it needs to be acknowledged that the exchange of letters between the Governor and the Chancellor has proved inadequate to the task of managing the Bank's performance. In future, the Governor of the Bank should be required to report regularly to the Chancellor and Parliament not just on inflation – where, as we have seen during Covid Bank staff have been adept at blaming external shocks instead of owning up to the Bank's policy mistakes – but also on money growth to ensure that big deviations such as occurred in the early phases of Covid are prevented in future.

Only with specific, narrowly focused reforms of this kind can we hope to set monetary policy on a path to better future performance.

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