Remember, remember

7 November 2022

Erik Britton

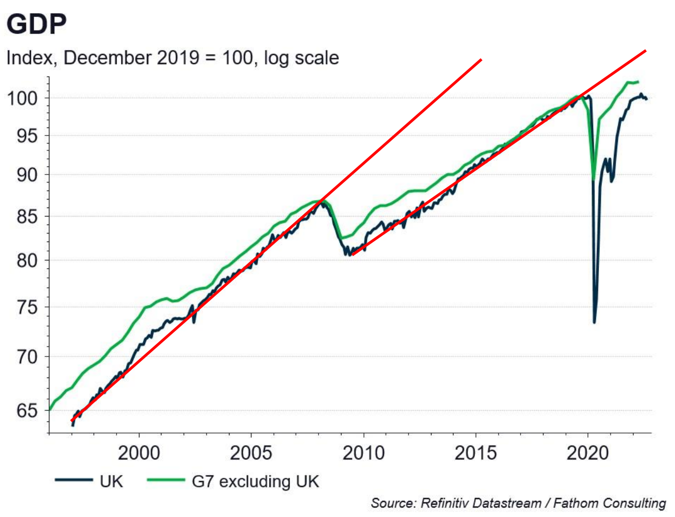
It was 417 years ago last Saturday that the Gunpowder Plot was discovered. The plot was a failed attempt to destroy and rebuild the way government was done. The gunpowder under the body politic was removed to a safe distance, and the plotters including Guy Fawkes were dispatched in various unpleasant ways that we are invited to remember every 5 November.

For a few weeks earlier this Autumn, another group of plotters briefly took the reins of power in the UK and attempted to redraw the way government is done, particularly in respect of economic policy. The attempt was shortlived and the ousting of the plotters was ignominious and memorable, if (thankfully) less violent than the end of Guy Fawkes. Some damage had already been done, with markets pricing a 'moron risk premium' into sterling-denominated assets during the brief Truss government — a premium that has not yet entirely dissipated.

Truss and Kwarteng placed a bomb under UK macro policy – it has since been removed, but the fragility of the policy framework has been exposed

It is easy to see what motivated the more recent plotters. UK macroeconomic policy has been nothing short of a disaster for at least the last decade, and arguably longer. Fathom's Emergency Monetary Policy Forum on Friday called for a dramatic reset in UK monetary and fiscal policy to tackle the profound economic problems of inflation and low productivity.

In an event hosted by Fathom Consulting and Chatham House, four distinguished former members of the Bank of England's Monetary Policy Committee — Willem Buiter, Charles Goodhart, Dame DeAnne Julius and Dr Sushil Wadhwani — concluded that the Bank had made significant errors in fulfilling its policy remit, and that a change of course was required. For its own part, Fathom is calling for a radical rethink of macroeconomic policy in the round.



UK macro policy needs a radical reset: it has been a disaster since the GFC at least

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The key conclusions of the Forum were, first, that UK economic policy has failed since the Global Financial Crisis. The economy's rate of growth has fallen from around 2% per year prior to the GFC to just above zero now. In Fathom's opening presentation to the forum, we argued that it was low-for-long interest rates that have eroded the economy's productivity. The forum was told: "We are overheating with growth at 0 in the UK. That's a pretty damning indictment. There has to be a better way." In other words, the UK is now in need of a policy reset.

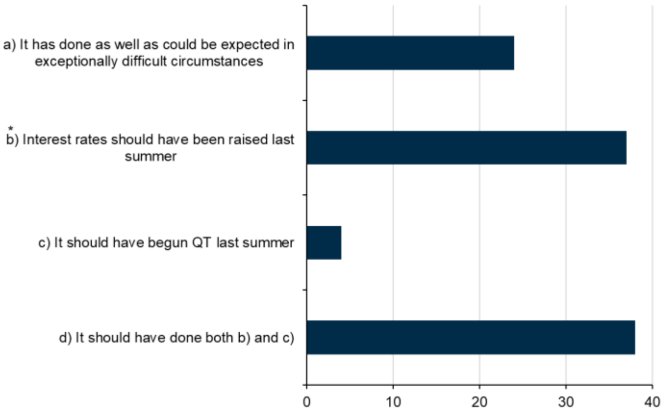
Fathom and Chatham House convened an Emergency Monetary Policy Forum to open the conversation

On bank rate: too little, too late

The view of both the panellists and those present in the audience was that interest rates should have been raised far earlier and far quicker than has been the case. Mr Goodhart raised the possibility that the MPC may have missed the boat: "You have to raise rates early and raise them aggressively. The Bank has waited and waited and waited, and now it's too damn late." The audience at Chatham House concurred: in polling, 75% believed the Bank had delayed too long, with 37% believing it should have started hiking rates last summer, and a further 38% that it should have commenced Quantitative Tightening at the same time too.

Has the MPC fulfilled its remit since 2020?*

Per cent



*Question in full "To what extent has the MPC fulfilled its remit since the pandemic hit?"

Source: Chatham House / Fathom Consulting

Models don't make forecasts, economists do

There was unanimous agreement among the panellists that the Bank's projection, which accompanied its November Monetary Policy Report, that inflation could drift smoothly back to target without further interest rate hikes, was unrealistic. "The belief that with 3% for the duration you can get inflation back to target, that's dreaming," said Mr Buiter. Mr Goodhart said he didn't think the Bank "had a leg to stand on" for this projection. Dame DeAnne also alluded to the possibility that the Bank's overemphasis on its (relatively opaque and complex) macro model as a means of justifying policy decisions might be harming its credibility – don't blame the model for unjustified assumptions, blame the forecasters.

The Bank risks losing credibility

Monetary policy is taking unnecessary risks with credibility and will need to tighten further as a result; fiscal policy is in a similar bind

Fathom has suggested in previous *Global Outlook* forecasts that the Bank was attempting to use its credibility to talk down the significance of rising inflation in the hopes that this would avoid the need to hike rates: to 'Fake it till you make it'. Dr Sushil Wadhwani, Chief Investment Officer of PGIM Wadhwani, said that in his view the Bank's latest attempt to use words rather than deeds to shift the dial had simply been confusing. "The loss of credibility matters hugely," said Dr Wadhwani. "People do believe the Bank matters — credibility is a very precious asset

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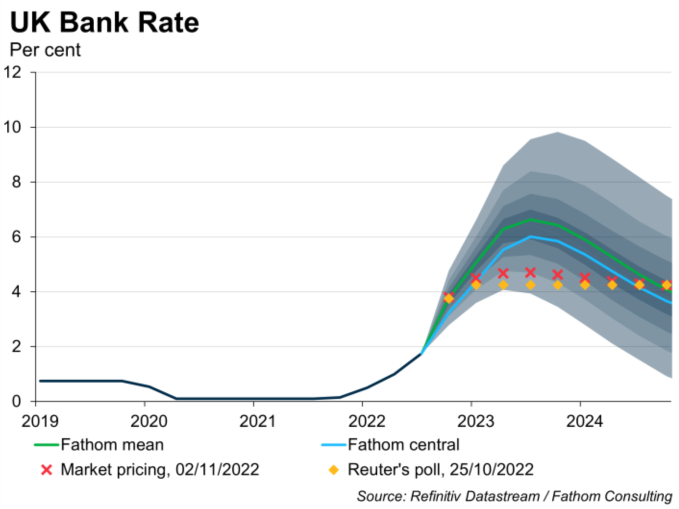
and its sad to see them begin to lose it… I was really puzzled by [the Bank of England communication of 3 November]. They did the right thing, putting rates up by 75 basis points, then unwound the effect by saying rates might not need to go up any more. It just seemed pointless.”

Rates may need to go higher than the MPC expects

The more rate hikes are delayed, the higher they may have to go. A year ago, when Bank Rate was 0.1%, the idea that it might reach 2-3% was considered high. It is a telling reflection on the times that panellists and audience members were throwing about numbers like 5–6% and nobody batted an eyelid. Dame DeAnne said: “It’s pretty clear interest rates need to go up quite significantly, probably to between 5 and 6%.”



In Fathom’s view, it is possible that a good outcome from the recent ‘kerfuffle’ (in Mr Buiter’s understatement) can still be achieved. To the extent that perennially low interest rates are part of the problem in the UK and elsewhere, part of the ‘solution’ might be to run a period of substantially higher inflation, getting higher inflation firmly embedded in expectations, creating a manageable degree of uncertainty about the competence of the macroeconomic policy authorities, driving nominal and real interest rates up at all maturities. Such an outcome would slay the zombies — the unproductive activities that have been allowed to dominate the UK economy (and others) since the Great Financial Crisis — and could move the economy onto a stronger trend growth path in the long term.

Policymakers should focus on retrieving a positive outcome from the current kerfuffle in the long run

We would not have done it like this. But, as the saying goes, you should never let a crisis go to waste. Remove the gunpowder to a safe distance, by all means: but take the opportunity to plot a different, better path for the UK economy in any case.

Further reading:

Global Outlook, Spring 2022: Fake it till you make it

Recession Watch: was the UK fiscal wobble a sign of things to come?

Viewpoint: the UK loses its magic money tree

Recession Watch: here we go again

Continued

Appendix: members of Fathom's Monetary Policy Forum

Willem H. Buiter, Adjunct Senior Fellow, Council on Foreign Relations, *former member of the Monetary Policy Committee (1997-2000)*

Willem Buiter is an independent economic advisor, speaker, commentator and expert witness. He is currently an Adjunct Senior Fellow at the Council on Foreign Relations. He was Global Chief Economist at Citigroup from 2010 to 2018 and a Special Economic Advisor at Citigroup from 2018 to 2019.

Previously, he was Chief Economist and Special Counselor to the President of the European Bank for Reconstruction and Development and an original member of the Monetary Policy Committee of the Bank of England. He was the Juan T. Trippe Professor of International Economics at Yale University and has also held academic appointments at the London School of Economics, Cambridge University, the University of Bristol and Princeton University. He is the author of 78 refereed articles in professional journals and seven books.

Charles Goodhart, Emeritus Professor of Banking and Finance, LSE, *former member of the Monetary Policy Committee (1997-2000)*

Charles Goodhart held the Norman Sosnow Chair of Banking and Finance at the London School of Economics (LSE) from 1985 until his retirement in 2002, when he became Emeritus Professor of Banking and Finance. He was elected a Fellow of the British Academy in 1990, and awarded the CBE in 1997, for services to monetary economics. During 1986, he helped to found the Financial Markets Group at LSE. For the previous 17 years he served as a monetary economist at the Bank of England, becoming a Chief Adviser in 1980.

Following his advice on overcoming the financial crisis in Hong Kong in 1983, he served on the HK Exchange Fund Advisory Committee until 1997. Later that year he was appointed for three years, until May 2000, one of the four independent outside members of the newly-formed Bank of England Monetary Policy Committee. He became an economic consultant to Morgan Stanley in 2009, until he resigned, at the age of 80, in 2016. It was during this period that he began work on the subject matter of his recent book, *The Great Demographic Reversal* (Palgrave Macmillan), with his colleague there, Manoj Pradhan. He has written widely on matters relating to monetary policy, especially central banking, and macro-economics.

Charles is the author of Goodhart's Law "that any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes".

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Dame DeAnne Julius, Senior Adviser, and Distinguished Fellow, Global Economy and Finance programme, Chatham House, *former member of the Monetary Policy Committee (1997-2001)*

Dame DeAnne is a senior adviser to Chatham House and a distinguished fellow in its Global Economy and Finance programme. She also serves on the advisory boards of Rock Creek Global (Washington DC) and the International Business and Diplomatic Exchange (London). She is a former member of the Temasek International Panel (Singapore) and the International Advisory Council of the China Investment Corporation (Beijing).

From 2014 to 2019, she was chair of University College London and from 2003 to 2012 she was chair of Chatham House. From 1997 to 2001, she was a founder member of the Monetary Policy Committee (MPC) of the Bank of England. From 2001 to 2004 she served on the Court of the Bank. Prior to joining the MPC, she held a number of positions in the private sector including Chief Economist at British Airways and Shell. Subsequent to the MPC role, she has been a non-executive director on the international corporate boards of American, British and Swiss companies.

She has written five books and numerous papers on subjects ranging from foreign direct investment to strategic planning and corporate governance. In 2012, she was made a Dame for her services to international relations. She holds a BSc from Iowa State University and a PhD in Economics from the University of California.

Dr Sushil Wadhwani, Chief Investment Officer, PGIM Wadhwani, *former member of the Monetary Policy Committee (1999-2002)*

Dr Sushil Wadhwani, CBE, is the Chief Investment Officer for PGIM Wadhwani, originally founded as Wadhwani Asset Management in October 2002. Prior to joining PGIM, Sushil served as the Founder and Chief Executive Officer of Wadhwani Asset Management. Previously, Sushil was a Member of the Monetary Policy Committee at the Bank of England. He also served as the Director of Quantitative Systems at Tudor Investment Corporation, Director of Equity Strategy at Goldman Sachs, and as an academic economist at the London School of Economics. Sushil is an emeritus governor at the London School of Economics and a Commander of the Order of the British Empire. Sushil earned a BSc, MSc and PhD from the London School of Economics and Political Science.

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