Inflation

I reproduce below my recent Conservative Home article

When I asked the Chancellor following his statement what advice he had received about the possible inflationary consequences of printing lots of money last year, he did not answer. He asserted yet again that the Bank of England is independent.

The Treasury regularly tells us the Bank of England is responsible for controlling inflation. They need to ask themselves why inflation has hit nine per cent, against a two per cent target, and why they think it could even go higher this autumn before falling away.

I cannot understand why Rishi Sunak claims the Bank is independent. The Chancellor chooses the Governor and has influence directly and indirectly over forecasts and policy at the Bank through joint official working and contacts with the Treasury.

Successive governments, with the backing of Parliament, have made substantial changes to the laws, rules and objectives and powers of the Bank over the last thirty years. When George Osborne selected Mark Carney he chose someone who was willing to use the Bank and its forecasts to support the Remain campaign in the referendum, in line with the Chancellor's thinking.

Gordon Brown changed the inflation target to direct the Bank,and Alastair Darling forced an interest rate cut during the banking crisis on a reluctant Bank to implement an agreed international Finance Ministers' strategy.

The Treasury respond by saying that what they mean by the Bank is independent is the narrower claim that it has sole control over money policy.

They accept that the Bank has been buffeted by political change. They lost control over managing the state debts and regulating the commercial banks, once thought to be important parts of central banking that were taken away from them.

Even this narrower claim is wrong. Over the last 14 years the main tool of monetary policy has been the creation of billions of pounds of new money by the Bank to buy up state debt. This has kept interest rates very low and would in normal circumstances be inflationary. Every pound of the £895bn created has been formally approved by successive chancellors.

Going further, every pound of bonds the Bank has bought has been underwritten by the Treasury. Chancellors have signed off to indemnify the Bank against all losses on this pile of assets. The Bank has an agreement from the Treasury that will top up its capital to a minimum level whatever happens.

That does not sound very independent and means chancellors need to watch carefully the liabilities the Bank is piling up.

I found it odd the current Chancellor seemed unwilling to talk about this. It has been on his watch that the Bank has bought £450bn of bonds, more than chancellors Darling, Osborne and Philip Hammond combined. Whilst he has also proposed and approved substantial increases in public spending and borrowing, the £450bn dwarfs everything else he has done.

Prior to the banking crash, people in advanced countries said that printing money and keeping interest rates artificially low was the kind of thing inflation-prone emerging market economies would do. The special circumstances of the banking collapse in 2008 did need these special measures to compensate for the destruction of money and credit taking place in the private sector.

There was also a good case for doing some more in 2020 to offset the collapse of activity brought on by lockdowns. I supported the money creation they proposed.

Continuing this policy throughout the whole of 2021, a year of fast growth and good recovery in the UK, was altogether more questionable.

Some people say inflation results from cost pressures and supply shocks. They blame current inflation on sky-high energy costs and surging food prices brought on by the Ukraine war.

It is true we are living through nasty hits from these forces. It is also true that British inflation was rising well before Russia invaded her neighbour.

China and Japan both rely on a lot of imports of energy but they still have inflation around two per cent, not near ten per cent. They did not allow a surge in money growth in 2020-2021, whereas the UK along with the US and EU did decide on a bulge in money growth, resulting in part from the money creation undertaken by the Bank.

Some people say inflation results from excess demand. If people have too much spending power for the capacity in the economy then prices rise quickly.

We can see some of this at work, as hospitality, travel and leisure businesses struggle to recruit enough labour to meet rising demand and need to pay higher wages and more for supplies.

The Bank points out in its defence to the charge that it has dropped the ball on inflation that there is little it can do if Russia disrupts energy and food markets. The only thing it can do if the economy is running too hot is to jack up interest rates to slow everything down.

There is some truth in these defences. It shows that countering inflation cannot be left to the Bank alone.

We need a supply side strategy from the whole of government to produce more energy, food, and other goods and services here at home to bring demand and supply into better balance. The Chancellor needs to produce policies which promote growth. Constantly hiking taxes and inventing new taxes will stifle investment, not encourage it.

Meanwhile the Bank does need to ask itself some tough questions about money. Why does it not have a target for money growth? Why does it ignore the impact of more created pounds and more credit on demand and prices?

It will be the Chancellor who has to tell us how the huge bond portfolio is doing, now bond prices have fallen markedly.