

The Treasury and Bank get it wrong again Conservative Home article

In the closing years of the Thatcher/Major Conservative governments Ministers accepted dreadful advice from the Bank of England and Treasury. They based UK economic policy on the European Exchange Rate Mechanism. I wrote a pamphlet, made speeches, lobbied Ministers not to do this pointing out it would lead to high inflation or recession. One Cabinet Minister agreed with me and a few economists and commentators. Labour, the CBI and TUC agreed with the officials. They had their way, caused a big inflation, then gave us a savage recession to correct the first error. Conservatives plunged to around 30% in the polls when the damage of the policy became clear and stayed there until the election which resulted in the loss of 178 seats.

The present government is too trusting of current Bank/Treasury advice. It has given them high inflation. The Bank has blamed the Ukraine war impact on energy and food prices yet Switzerland, China and Japan avoided such a result despite sharing the same world inflation pressures. The UK inflation rate was already 275% over target before the war. Now the Bank threatens to make the opposite mistake and cause a recession. It ignored the advice I and some others offered not to print so much money in 2021 and buy so many bonds at crazily high prices. It now wants to undermine the bond market further with large sales of bonds at ever lower prices.

It is vital that before Parliament breaks up for a long summer recess the Chancellor changes economic policy and the Bank of England produces the results of its review of its economic model and forecasts. The country needs and deserves a better policy. There are ways to bring inflation down faster and grow the economy more. We need to lift more people out of real income hits and low spending power through better paid jobs. The Conservative party also needs to be more competitive, to avoid a Labour government which would make the economy worse and would double down on policy tendencies that are creating inflation and slow growth. The danger is that people, disappointed with the last couple of years of economic performance, vote to impose a worse approach on themselves in frustration.

The Bank of England has wisely and bravely admitted that it has been getting inflation forecasts horribly wrong. It admits its current model of the economy does not work and has said it now ignores most of what its model says. This is dangerous. The whole purpose of the Monetary Policy Committee is to forecast inflation, then

to adjust policy to keep it around 2% in the light of the forecast. Two and three years ago the Bank was confidently forecasting inflation would stay around 2%. It soared to over 11%, way outside acceptable margins of error in what is a difficult task. The MPC cannot have a clear take on what to do all the time it cannot define the extent of the inflationary problem ahead. The Treasury and the Treasury Committee of Parliament should urge the Bank to make early changes to their model. They need to back test the new model and change it sufficiently so it can forecast what has happened. Then we might have a model that the Bank can rely on more when charting the future. I doubt they can get a model to work without including a bigger role for money and credit, which they currently ignore in their MPC publications. We have a Money Policy Committee that does not do money.

The Bank should study the Peoples Bank of China's critique of the Federal Reserve Board of the USA which made similar mistakes to the Bank of England for similar reasons. China currently has inflation at 0.2% and did not experience an inflation overrun from world oil and food prices surging over the Ukraine war. China criticises the over expansion of the Fed's balance sheet. There is now a danger that the Fed and the Bank of England over contract their balance sheet as they try to correct past mistakes. In doing so the Fed helped bring down some regional banks. The Bank of England helped bring down the highly leveraged Liability Driven Investment bond funds, including the large holding in its own pension fund. Both Central Banks stopped the damage spreading by creating more money to offset the big sales of bonds they were undertaking to drive up interest rates.

If the Bank sells fewer bonds the Treasury will be spared some huge losses. They should stop shrinking their balance sheet so much before something other than LDI funds breaks.

The Treasury has set itself against any tax cuts on the grounds they would increase the deficit and therefore inflation. Meanwhile the Treasury approves many new increases in spending both for new programmes and to compensate for inflation of costs and poor productivity in many parts of the public sector. Inflationary increases in public spending are clearly generally inflationary. The CPI is now powered upwards by service sector inflation. The Treasury needs to be encouraging higher pay for higher output, with something for something public sector pay deals. It needs to put a stop on more recruiting other than front line and uniformed staff into the public sector, promoting and streamlining from within. NHS England has recruited an extra 3500 managers this

Parliament to supervise a big fall in productivity. This has to be reversed.

There are tax cuts that do not lead to tax revenue losses, as Ireland shows us. Their Corporation tax rate half the UK's produces four times as much revenue per head as the UK rate. We need a supply side revolution, with business expansion and more investment in extra capacity. Lift IR 35 from the self employed. Raise the VAT threshold for small business. These measures will boost output. Suspend VAT on fuel and see inflation fall. Take carbon taxes off high energy using firms to avoid closures and relieve cost pressures.

A new economic policy needs to rely on selective tax cuts and supply side measures to bring inflation down, and on driving a productivity catch up or recovery in public services to help bring state borrowing down. The Bank hitting mortgage holders ever harder to reduce their spending will not cure inflation, With government pressing for savers to get more interest their demand can rise as their children's demand falls as a result of the mortgage squeeze.