Bank of England must second guess future

Agenda

Interest-rate changes are long-term economic tools to be used with care

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Sensible policy makers act ahead of problems. The question is how pre-emptive should they be? This is a question testing the minds of the US Federal Reserve Board and the Bank of England.

Monetary policy takes time to fully feed through. This may be up to two years. So an interest rate increase now may not fully affect the economy until people are planning their summer holidays in the mid-term of the Government, by which time if they are going to France, euros and not just francs will be needed.

Although the US and UK both enjoy low inflation, central bankers in both countries are not convinced it will last. Their concern is understandable. Even though the global disinflationary environment points to low inflation for some time this does not mean an economy can grow above trend indefinitely.

There have been many similarities between the US and UK economic cycles. Both were helped by currency depreciation, low interest rates and some fiscal rebalancing. Unemployment has fallen sharply, but labour market flexibility, international competitive pressure and cost cutting prevented any resurgence in wage inflation. Job insecurity prevailed for some time, so until recently much of the public did not share in the feelgood factor, although corporate profitability rose, propelling stock markets on both sides of the Atlantic higher.

As similar as much of this cycle has been, there is a dramatic difference. America has invested heavily and is benefiting from the revolution in the high-tech sector, which is only 5.5% of the economy but has accounted for about 40% of its growth in the last few years. Yet prices are falling in the high-tech sector.

So the US is experiencing strong growth, which in previous cycles would have caused a surge in inflation and prompted the Fed to be pre-emptive, aggressively raising rates. Yet if low inflation continues, US rates are already high enough. This is the dilemma the Fed faces as it meets this week to decide on rates.

In Britain it is the service sector driving the economy and within it costs and prices are rising. This contrasts with manufacturing, where costs have fallen in recent months.

While continued low inflation in the US should give us confidence, the Bank of England cannot see it as a guarantee that inflation will remain low here. This was evident from last week's quarterly *Inflation Report*, when the bank said: "Despite the rise in the exchange rate, inflation is more likely than not to be above the target two years or so ahead unless action is taken to slow the pace of expansion." As a result the Bank signalled they will raise rates.

While there is a need to be forward looking, the problem is the decision to raise rates may be based on forecasts that may not prove correct. Yet, if the bank was to wait until it sees the whites of inflation's eyes, it will be too late. But higher rates will compound problems.

A few years ago, two economists at the Bank of England, Joe Ganley and Chris Salmon, analysed the response to unanticipated changes in interest rates. They found the output response in 24 sectors of the economy varied significantly. An unexpected monetary tightening had a muted impact on the service sector, while manufacturing and construction were hit hard. Some of the industries most affected consisted of small firms, suggesting credit-market imperfections may play a role in the monetary policy transmission process.

This analysis is relevant now. Although another tightening is expected the chances are the bank's new found independence could push interest rates up by more than industry is prepared for. This suggests further pain.

Even though manufacturing may be suffering from a strong pound this will not stop the bank from continuing to raise rates if they believe the Government's inflation target will not be met. This will exacerbate the imbalance in the economy. As the former number two at the Fed, Alan Blinder, wrote last autumn: "The need to reduce large fiscal deficits [around the globe] dictates that budget policy remains a drag on total spending for the foreseeable future, regardless of the state of the macroeconomy. With the fiscal arm of stabilisation policy thereby paralysed, a central bank that decides to concentrate exclusively on price stability is, in effect, throwing in the towel on unemployment."

The *Inflation Report* shows the Bank of England is clearly signalling its intentions. This is welcome. Given the bank's target and the need to be pre-emptive the question is can the Government do anything to ease the pain? The spirit of Labour's manifesto means the Chancellor cannot raise taxes to curb consumption and prevent interest-rate increases. But he could try and pro-actively help industry, possibly by tax incentives to boost investment, and also by trying to weaken the pound, either by policy statements or intervention.

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