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MONDAY VIEW

By Gerard Lyons

The Bank must hold its nerve and not put up interest rates

THE Bank of England is under intense pressure to raise interest rates from their current level of 0.5pc.

This week the Monetary Policy Committee meets to decide on rates. Last month three members voted for an increase, up from two the month before.

That still leaves six members wanting to keep rates unchanged. Last Thursday the European Central Bank hinted that it may raise interest rates in April. Whilst that does not impact on the Bank of England, it has added to speculation.

A rates increase would be disastrous for the UK economy. It would be the wrong policy for the wrong reasons at the wrong time. The Bank should hold its nerve and stay put.

There are two main reasons why interest rates should not rise. First, higher rates would not address the factors that have led to rising prices.

Second, rate hikes are not appropriate for a fragile economy already facing challenges such as high youth unemployment and a large budget deficit. Whilst firms may try to pass on higher costs, it is hard to see these sticking if demand is fragile.

The impact of rising prices has to be taken seriously. With wages hardly rising, an increase in prices acts like a tax increase as it eats into disposable income.

In January, inflation reached 4pc, double the Bank's 2pc target. The problem for the Bank is the source of these higher prices. This includes rising food and energy costs, which are set in world markets, and higher utilities and transport charges.

When this happens, the traditional way of addressing inflation, by raising rates, does not work. Just as King Canute could not stop the tide, higher rates would have no impact on the factors that have driven up prices.

To put this in perspective, if one took out the tax, food and energy rises, core inflation would be 1pc. Of course, when prices rise, there is a feeling that the Bank of England should do something. But if it did, it would only make the situation worse. If rates were to rise they would squeeze the remaining few pounds people have to spend.

Some economists have argued that rates only need to go up by a small amount and so there is no need to worry. That view is misplaced. Markets don't work like that and would expect further increases. In recent months, higher market rates have pushed up borrowing costs for many firms and mortgage holders.

Interest rates also have to be set with the economic outlook in mind. There is still much debt that needs to be repaid by the government, people and firms.

With fiscal policy being tightened aggressively, it is vital that rates stay low, otherwise the economy could fall into recession.

Big, cash rich firms already lack the confidence to invest. Meanwhile, higher rates may make it harder for small firms to take on the working capital needed to achieve economic recovery. The fragile housing market and impact of spending cuts make some regions of the country more vulnerable to any increase in interest rates, however small.

The jobs market is not good. Unemployment is high. Some people have moved from full-time to part-time work. Graduates are taking on low-skilled jobs, displacing others.

MANY firms are retaining staff in the hope that things improve and because it is expensive to rehire skilled workers.

Savers are certainly suffering at present. But rates will return to normal in a few years. For now, the economy is suffering from a lack of demand, and there is a need to restore growth and confidence. Low interest rates are part of this process.

The Bank needs to keep explaining its thinking, as this would help keep inflation expectations in check. For now, higher rates are neither appropriate to handle current price shocks, nor sensible in an economy facing significant challenges.

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