Time for George to lay fears of inflation bogeyman to rest

ECONOMIC VIEWPOINT

The Bank of England must learn from its mistakes and does not deserve independence, says **Dr Gerard Lyons**

BASE RATES would be much higher than their present 6.75% if the Bank of England had its way. Who knows, rates could already have reached 8%, if not higher. Instead of merely slowing down, the economy could have been heading into recession.

This sounds familiar. Back in the early Nineties, the Bank was a keen supporter, along with others, of sterling's membership of the exchange rate mechanism. That policy also drove the economy down.

There is nothing wrong with making mistakes. It is just that the Bank makes the same ones continuously. It has an over-zealous desire to achieve low inflation and thus prove its credibility. This is at the expense of the rest of the economy, keeping output low and unemployment high. The Bank pushes for monetary overkill, where base rates are too high.

The Bank of England greatly influences the City's thinking. Thus the market has been too pessimistic about inflation. Last December, for instance, the futures market expected base rates to reach 8.75% by now.

Through this year, however, interest-rate expectations have continued to fall. Only during the last few weeks did the market decide base rates have peaked.

Bank of England Governor Eddie George has been calling for a rate increase since May's monthly meeting with Chancellor Kenneth Clarke. Then, I was one of the few City economists who thought Clarke was right to resist George's demand for higher rates. Subsequent data have certainly justified the Chancellor's decision.

George will have an opportunity on Thursday to undo some of the damage and retract his demand for higher rates. I would advise the Chancellor to remain one step ahead and demand an immediate base rate cut.

This is probably too optimistic, as the Bank and the markets will want to see what is unveiled in November's Budget before accepting any easing. But the next move in rates will be down, although the much-needed cut may have to wait until next year.

There are many reasons why the Bank has pressed for higher rates. What stands out is a lack of belief in the economy's ability to grow without triggering inflation.

Just as a young child fears a bogeyman in the dark, an inflation risk is seen at almost every corner.

But when you turn on the light and show the child there is nothing there, he or she may still fear the bogeyman the following night. Inflation is the Bank of England's bogeyman.

There are valid reasons to be concerned about inflation. Britain seems to like inflation — witness the way people crave for higher house prices and demand rising pay. Excessive, and in some cases obscene, boardroom pay increases hardly set a good example.

Yet the industrialised world is undergoing a radical shift to an era of low inflation. Britain appears to be sharing in this process. Intense competition is forcing companies to keep costs and wages down.

THE RESULT is low inflation but at the expense of greater job insecurity and low real wage increases. Little wonder the feelgood factor has failed to materialise. Consequently, consumers now demand value for money, with retailers and producers unable to pass on higher prices.

The Bank's behaviour has been similar to that of America's Federal Reserve. It has followed an intermediate growth target. The idea is that if the economy is growing above trend, rates should go up as inflation is around the corner.

Britain's trend growth rate has been low, primarily because there has been insufficient previous investment. America was in the same boat. There, misplaced inflation fears failed to materialise in recent years as companies used existing capacity and labour more frequently than before. The same may be true in Britain.

Clearly if the economy grows so strongly that it threatens inflation, there is a case for higher base rates. But we are a long way from that.

Hopefully, recent expertise will dampen enthusiasm for an independent Bank of England, free to decide interest rates on its own. British governments have shown they cannot be trusted to run the economy in the long-term best interests of the people. Despite this, the Bank has yet to show it can be trusted solely with controlling monetary policy.

The Bank: no excuse for continual forecast revisions

Not only could independence result in overkill as rates rise too far, but also it is not democratic. When was the last time you voted for the Bank of England's Governor? At least the Government can be voted out of office. And it does not guarantee consistency between monetary and fiscal policy.

The Bank could argue in its defence that it is trying to achieve the Government's inflation target. Yet this is no excuse for the Bank having to continually revise its inflation forecasts downwards.

The inflation target is low although the Chancellor did make it more flexible this summer.

Perhaps the Bank should be given twin objectives that recognise there is a trade-off to getting inflation down.

In the US, the Federal Reserve has to keep inflation down and maintain stable employment conditions. Jobs are important, with the employment report being the most important influence on US interest rates. In Britain, jobs appear of little importance in policy making.

As my four-year-old daughter starts school this week, I hope that she, like other children, will learn from the many mistakes she will undoubtedly make. I am surprised that, after 301 years, the Bank of England has not managed to master this basic habit.