The Bank reflects too much on inflation

The Bank of England's Monetary Policy Committee is overly concerned about rising prices, says Gerard Lyons. The danger is that recent interest rate hikes could well be forcing us into an unnecessary slowdown.

Slowdown is inevitable and recession possible as the pound's strength and high interest rates bite. Misplaced fears about inflation have already led to a tight monetary policy that will lead to weak, below trend growth, pushing unemployment higher.

The pound's exit from the Exchange Rate Mechanism in September 1992 triggered an economic recovery that has lasted six years. Normally by this stage of the economic cycle the UK would have run into either an inflation or trade problem. This time both problems have been avoided. Yet rather than sit back and accept that the economy has enjoyed sustainable growth, fears about inflation have dominated the policy debate during the last year.

Since being made independent last May the Bank of England has hiked rates six times, from 6% to 7.5%. This has contributed to the pound's strength, taking its toll on the economy, hitting exporters, manufacturers and the tourist industry. The economy is growing at half the pace of a year ago and slowing.

Ahead of the general election, the Labour party boxed itself in on fiscal policy. In order to convince voters it could be trusted, Labour promised no income tax rises and committed itself to tough spending plans. This effectively removed fiscal policy as an effective tool to control the economy – which in turn shifted the emphasis onto monetary policy and the Bank of England. Even though the Chancellor is boosting spending for the rest of this Parliament, short-term control of the economy remains with monetary policy.

The Bank of England has been heavily criticised for raising rates. Yet the Bank's Monetary Policy Committee (MPC) has two defences. First, the strong pound has been the reason for manufacturers' problems and the strength of sterling is not solely due to higher interest rates. There have been many factors explaining the pound's strength, including steady growth and a safe haven from problems ahead of economic and monetary union.

The MPC's second defence is they are just doing their job. Whatever you may think of the MPC, at least all its nine members can read! The remit the MPC has been set by Parliament is a tough one. The Bank of England Act came into effect on 1 June. The Act states: "The objectives of the Bank of England shall be (a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."

Although there are two parts to this remit, only the first really counts. Note that part (b) is only subject to achieving part (a). Although the Act says "price stability", the MPC will be judged by its success in hitting a 2.5% target for underlying inflation (so-called RPIX). It is only after the Bank has achieved the inflation target that they need to take into account growth and employment.

To achieve their objective the Bank of England's policy has been straightforward: to raise interest rates and slow the economy. So if it isn't hurting, it isn't working. Output has slowed sharply and there is evidence of a more general slowdown across the economy. Business surveys point to worse to come. So the policy is working. If the Bank had been set twin objectives, like the US Federal Reserve, then monetary policy would have to take into account the impact on growth and the economy.

The Bank of England is expecting a sharp slowdown next year, with a one-in-eight chance of the economy actually contracting. The economy is then expected to rebound to trend by the end of next year, but not before higher unemployment has curbed wage pressures.

But is this slowdown we are forcing ourselves into really necessary? There is no doubt the economy is vulnerable to problems in the world economy, but this is very different from a slowdown that is a direct consequence of economic policy at home. Monetary policy is very tight.

Is there really an inflation problem? I don' think so. The evidence is certainly far from conclusive. Admittedly, earnings are growing at a faster pace than the MPC would like. If productivity growth averages 2% then, to achieve a 2.5% inflation target, earnings can grow by 4.5%. But so far this year, earnings have been growing at a faster pace than this, feeding concerns that a tight labour market is putting upward pressure on wages, leading to higher inflation. But retailers have found it hard to make price rises stick.

Producer prices are subdued, helped by the strength of the pound. Even though the strong pound has helped curb inflation this is not how the MPC has seen it. They see the appreciation of sterling as having a temporary restraining influence on inflation. That is, domestic inflation is high and were it not for the pound's strength, overall inflation in the economy would be much higher. Hence their concern.

There are three measures of inflation in the UK. RPI is the headline rate of retail price inflation but it is not the measure that the Bank of England has to target. The reason for that is that when interest rates rise to tackle inflation this pushes mortgage costs up and increases the RPI. Thus the Bank targets RPIX, which excludes mortgage rates and thus avoids the distortion of higher interest rates pushing the rate of inflation up. Yet RPIX can also be distorted by policy, when Budget changes force up excise duties.

In the past the Bank of England used to argue that RPIY is a better measure, because this additionally removes the impact of Budget changes and thus leaves a measure of inflation free from any policy impact. So changes to interest rates and to excise duties do not affect RPIY. Interestingly, RPIY is now at 2%, the same rate as last May, having been higher in between.

At least low inflation has left corporate balance sheets in good shape. They need to be if the economy is to avoid recession and cope with the consequences of recent interest rate hikes. ●

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