The Case for Low Interest Rates

Background

Since being made independent the core remit of the Bank of England, as determined by the Chancellor, is to meet inflation targets. The secondary requirement is to maximise economic growth and employment. The argument being that a stable low inflation economy will provide the business environment to ensure the secondary requirements.

The Monetary Policy Committee (MPC) of the Bank of England will decide to increase interest rates in periods of economic growth when there is a danger of 'demand pull' inflation (when demand for goods & services is exceeding the supply, assuming the economy is at full capacity). Increases in interest rates, in these periods, will slow down consumer spending.

Requirement for Economic Growth

If the UK economy fails to reach the top end of the Treasury target for growth there will be an increase in unemployment.

Current Thinking on Interest Rates

On the 5th October 2006 the Bank of England MPC decided to maintain interest rates at 4.75%. In advance of the next rate decision on the 9th November, there are perceived inflationary pressures in the economy which some commentators argue should led to an increase in interest rates. Indeed, it is the case that the Government's measure of inflation – the Consumer Price Index (CPI) – has been consistently above its target of 2% for the last six months, however we should consider that in the last reported month it has fallen.

Public Opinion on Interest Rates

Survey's confirm that the threat of interest rate hikes have a definite impact on consumer psyche. This fact is confirmed in figures recently published by the Office of National Statistics (ONS), that UK retail sales fell in September after the last increase in rates in August. This is of significant concern when we consider that consumer spending is one of the main drivers of UK economic growth.

It is not insignificant that the recent marginal decline in the CPI was mirrored by an increase in the Retail Price Index (RPI). The ONS explanation for this effect is the net result of mortgage interest payments increasing in September, as the August interest rate rise was passed onto borrowers.

Manufacturing Investment

The perception of increasing interest rates is having has a major impact on investment in an already fragile manufacturing base. Basic economic theory will tell us that any investment must be qualified by the question – *will the investment yield* *enough extra profit to pay back, with interest, the loan used to finance the original project?* In practical terms as interest rates increase investment in industry declines.

Amicus warns that the Bank of England must not increase interest rates in November. Although there are some pressures for a rate rise, the Bank must take account of the fact that growth for 2007 is expected to slow below current expectations. Any increase will jeopardise recent improvements for the UK manufacturing base.

Threat & Impact of a Further Increase

On 20th September the Bank released the minutes of its September meeting at which MPC elected 8 to 0 to keep rates on hold (a result which tells us little after August's surprise ¼% point hike, to 4.75%). Within the Minutes the Bank noted that the financial markets were already pricing in a further 0.25% hike before the end of the year.

We are extremely concerned that a further increase appears to be already accepted despite the fact that the full impact of the August rate increase, whilst already reflected on the high street, is still to be fully felt.

Evidence from mortgage lenders suggests that, while house prices rose by 1% in August there were signs that growth had continued to "moderate", hampered by the higher interest rates and energy bills.

Coupled with this are figures from the Chartered Institute of Purchasing and Supply which warn that manufacturing activity has slowed to its weakest pace for five months in August.

Amicus is concerned that the Bank of England is using short-term inflation expectations as the justification for a further rate hike. We believe that the August rate hike was unnecessary (irrespective of what lagging inflation data may have shown) and that a further rise is unnecessary in November. Further, the Bank should stand ready to cut rates in response to easing energy prices and declining global economic activity.

With a potential short term decline in consumption we should also consider the other cause of inflation. No doubt some economic commentators are concerned about the potential of inflation being caused by increasing wage demands (which themselves would be fuelled by the increase in RPI).

Amicus believes that sufficient evidence exist to show that - the continuing stability of pay settlements in manufacturing means there are no wage inflationary pressures building up that should concern the MPC.