

# The Argument for an Interest Rate Cut

## 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 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.

## The Economy in 2006

Interest rates in January 2006 stand at 4.5%, that being a 0.25% reduction from the same time in 2005 (having been cut once in August).

Significantly the current headline inflation rate is marginally above the target figure.

The Chancellors forecast for economic growth in 2006 was revised down in the last Pre-Budget Report (PBR). Despite this there is the potential, in the economy, to meet the higher end of the Treasury forecast of 2.5% growth in 2006. This will only be reached if interest rates are cut in order to stimulate demand.

## The Case for a Reduction in Interest Rates

The basis for any decision not to cut interest rates will be based on two main factors, which can be questioned, those being:

- the view that the economy is at full capacity and that any additional demand will create inflationary pressure.
- that Increases in oil prices are already generating inflationary pressures.

However both these assumptions are unfounded.

On the first point, the PBR shows that there is 'output gap' in the UK economy (a differential in the actual growth rate and the long term sustainable growth rate) of around -1.75 of GDP in 2005. This clearly demonstrates that there is capacity to increase economic growth without creating inflationary pressures.

On the second point, there is little evidence that recent increases in oil prices are currently having an inflationary impact on the UK economy. In fact the Consumer Price Index (CPI) measure of inflation has reduced since its peak in September, with both the headline figure and the figure less energy prices reducing. If increases in oil prices were having a direct effect on inflation we should expect to see both measures increasing.

## **Requirement to Increase 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. Slow economic growth in 2005 has already resulted in an increase in unemployment.

## **Forecast for Manufacturing**

The Treasury forecast is for manufacturing output to grow in 2006 between 1 and 1.25%. In 2005 manufacturing moved into recession, with a fall in output of 0.5%. This resulted in not only a down turn across the whole economy (as investment and exports were reduced) but also resulted in total employee job losses of 115,000 in the 12 months to October 2005.

If interest rates are not reduced in order to stimulate economic growth it is inevitable that these trends will continue with a potential loss of a further 80,000 manufacturing jobs in 2006.