



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 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.

Current Thinking on Interest Rates

On the 8th June 2006 the Bank of England MPC decided to maintain interest rates at 4.5% (The previous change in interest rates was a reduction of 0.25 percentage points to 4.5% on 4 August 2005).

It is not insignificant that this decision was welcomed by both the TUC and the CBI.

Ian Brinkley the Chief Economist of the TUC, welcomed the decision citing the recent increase in output from the manufacturing sector. He warned that, "It is far too early to put this upturn at risk with a rise in rates".

Commenting on the same decision, the CBI Chief Economic Advisor said, "The economy is recovering from the doldrums of last autumn, raising some fears of the prospect of a modest acceleration in inflation. So far, though, this is unproven, and any upward move in rates would have been premature. Leaving rates unchanged sends out a confidence-enhancing message of stability."

The Economy in 2006

Gross Domestic Product (GDP) grew by 0.6% in the first quarter of 2006, with growth unchanged from the last quarter of 2005. The level of GDP is now 2.2% higher than the first quarter of 2005.

Manufacturing output increased by 0.6% in the three months to April 2006 compared with the three months to January 2006.

In June 2006 the Consumer Price Index (CPI) stands at 2.2%. Significantly this current headline inflation rate is marginally above the target figure.

This will inevitably lead commentators to speculate on a potential increase in interest rates in the short term. However we need to analyse the cause of the increases in inflation. The largest upward effect came from gas and electricity bills which continued to increase by more than a year ago, reflecting the phasing in of recent tariff increases from major suppliers. This is not a basis to suggest that a 'demand pull' effect is taking place in the UK economy.

We should also compare the UK situation with our European counterparts. As an internationally comparable measure of inflation, the CPI shows that the UK inflation rate is slightly below the average for the European Union as a whole. The provisional inflation rate for the enlarged EU 25 in April was 2.3%, compared with the UK figure for the same month of 2.0%.

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 not increased.

The basis for any decision to increase interest rates will be based on the assumption that the economy is at full capacity and that any additional demand will create inflationary pressure. Such an assumption would be unfounded. The Chancellors last PBR suggested that there is an '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.

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 increased at this stage it is inevitable that the slight recovery in the manufacturing sector will be under threat.