

PRESS ARTICLE

WHERE NOW FOR INTEREST RATES? | JUNE 2011

There has been much speculation on the future direction of interest rates as a result of the Bank of England's latest Inflation Report.

If you believe the speculation we can expect interest rates to rise significantly and very soon, causing even greater hardship to the UK consumer, especially those whose mortgages are not on fixed rates.

But is this really the case?

The Bank of England report talked about lower than expected growth in the economy and a rise in inflation, caused by higher food prices and fuel bills. It is clear that the Bank still believes inflation will fall back towards its 2% target in 2012, although the Bank's Governor, Mervyn King (now Sir Mervyn King), has changed his position slightly, saying that inflation "may not fall back as strong as expected".

You may ask however, are inflation and interest rates linked?

High inflation is generally seen as a bad thing, it means take home pay does not go so far due to increased prices and therefore people spend less, which then means businesses do not grow as quickly and this affects the overall economic growth.

The main weapon against rising inflation is usually higher interest rates. The theory goes that if you increase interest rates, you decrease the amount of money people have to spend as the cost of borrowing money will rise. This in turn means businesses charge less for goods and services to encourage spending, which also reduces inflation.

Interest rates are set by the Monetary Policy Committee (MPC) and for more than two years now the committee has voted for no change in rates, however, recently the votes have been getting tighter. Last month three of the nine members voted for an increase in rates and it would only take two more members of the committee to change their minds for us to see higher rates.

The question must therefore be asked why the MPC would consider increasing rates now if inflation is set to fall anyway, as any rise in interest rates would increase costs for many UK businesses and therefore effect economic growth.

The Bank already has a gloomy outlook for economic growth reducing their forecast for 2011 down to 1.75%. Would they really want to make the situation worse by increasing interest rates?

Although the conventional course of action would be to raise interest rates to dampen inflation, there is nothing conventional about the times we live in. At this stage of the economic cycle, having come out of recession over a year ago, we should be seeing stronger economic growth, but we aren't and here lies the problem.

It seems that the MPC sees higher inflation and low interest rates as preferable to increasing rates and potentially damaging the fragile recovery. Sir Mervyn acknowledged, however, that "bank rates will need to rise at some point, it cannot stay at this level indefinitely".