Does the MPC need to tighten? If so, how?

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The MPC left policy on hold in January, in line with market expectations. However the inflation background looks increasingly uncomfortable over the next two years and the committee's credibility is at stake, however, raising the Bank rate from its current level of 0.5%, may risk sending the recovery into reverse.

We argue that one solution could be to keep interest rates steady, but to start to reverse some of the Quantitative Easing. The MPC left the stance of policy unchanged in January, with the Bank rate remaining at 0.5% and the level of outstanding QE purchases at £200bn. Recent polls have shown that this was the unanimous expectation of economists. In line with the usual practice after an 'on hold' decision, the committee chose not to issue an accompanying statement. However the discussions at the meeting were probably far more interesting than the result, the reason being that members are probably looking at the inflation outlook with increasing concern.

We have revised our in-house inflation forecasts with the view that the CPI measure will rise a little above 4% towards the middle of this year, and a risk that this could be 0.5% or so higher than this should the 2.5% increase in VAT be fully passed through. Moreover some commodity prices have continued to surge. For example, wheat prices are 47% higher than a year ago (in US dollar terms), and corn has leapt 71%. Meanwhile copper price have reached record levels already this year, and aluminium and lead prices have both hit fresh recent highs. And of course, oil prices are also above $90 per barrel. The likelihood is that unless these trends go into reverse, the effects will linger for some time within the UK inflation statistics and accordingly we see a real possibility that inflation stays above the 2% target throughout the course of next year.

Indirect tax increases aside, the reason for the majority of the inflation overshoot has been the surge in global commodity costs and, arguably, the effects of sterling's previous depreciation. Trying to squeeze the domestically generated elements of inflation via raising interest rates might bring inflation back to target next year, but at the risk of sending the recovery into reverse. An interesting comparison would be to look at the situation in the second half of 2008, when CPI inflation rose above 5.0%.


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Would a rate increase then have been the correct response? With the UK economy already in recession and the world financial system on the verge of collapse, absolutely not. But 2008 was an extreme example and the risk is that with inflation having been above target for around 80% of the time over the past five years and with market derived and survey measures of inflation expectations rising, the Bank of England risks a loss of credibility if inflation is stickier than it has been forecasting and it does nothing. Indeed the money market yield curve has steepened to the extent that is now pricing in two 0.25% hikes during the second half of the year.

We are leaning towards the view that the MPC probably should tighten at some point over the next few months. However this should take the form of holding the Bank rate steady at 0.5% and, instead, start to reverse some of the QE, thereby sparing households and firms the additional pain of higher interest rates in an already difficult year. This would represent a change in the MPC's exit strategy, which is to move interest rates up to a certain level first and then to start selling gilts. We think this would be a way of maintaining the MPC's credibility while capping the downside risks to the real economy.