The Bank’s interest rate policy

I have set out before the issues surrounding the Bank of England’s powers . What is not in doubt is the Bank of England has the independent duty to set interest rates. There is political agreement by all main parties that they should have and do have this power. There is usually no government or official opposition criticism of the way they use this power to show people it is independent.

In a democracy there should however be proper debate about how this aspect of economic policy is conducted, and there are plenty of external commentators who express views and provide free advice to the Bank. The last two weeks have been mainly about the level of interest rates needed in the UK to control the inflation that has been allowed to develop. The important statement came on Thursday of last week from the MPC of the Bank when they told us they were going to start selling bonds out of their portfolio. The purpose of this is to lower the price of bonds and to increase longer term interest rates. The bonds after all had been bought to do the opposite, to raise their price and cut rates. The accompanying statements and forecast were interpreted by the market as meaning there were substantial short and longer term rate rises to come, which triggered a progressive sell off of bonds.This was on top of a global sell off triggered in the USA by the Federal Reserve Board who also signalled higher US rates and a large selling programme of US bonds which hit UK and European bonds too.

Some market participants criticised a couple of the measures in the Financial Statement on the Friday but the main focus of the gilt market remained on rates and bond prices. The markets had not been unsettled by the very expensive one off help for business and household energy bills announced a week ago Wednesday. The selling pressures in the market accelerated during the following week, reaching a crescendo on Wednesday.

The Bank then produced a statement which said it was changing policy dramatically to launch a new round of Quantitative easing with buying of longer bonds because they had come to see long interest rates were too high. This was argued on financial stability grounds. Many pension funds have geared positions in gilts, and were finding it difficult to raise money to pay the extra calls on their geared derivatives. Bond prices on Wednesday were wildly volatile on news of Bank intentions. Nothing changed on Wednesday concerning tax cuts to affect prices .It should be clear to anyone the extreme volatility on Wednesday was about the Bank’s interest rate policy, not a delayed response to the Financial statement.

The Bank’s statement went on to say the bond buying would end after two weeks and then sales of bonds would resume, and interest rates generally would rise. It seems that the part of the Bank that rightly worries about financial stability wants a different policy to the Monetary Policy Committee. I hope the Bank will think through what level of rates they think necessary to bring inflation down to the targets they now forecast they will hit, to give greater clarity. If it allows markets again to think it wants higher longer term rates it will create a nasty slump and balloon the very government deficit being argued about.I doubt the Bank can resume bond sales anytime soon without forcing rates too high.

Of course the Bank needs to do enough to bring inflation down. Its own forecasts say it has. It needs to tell us more about how it judges the rates needed to do this. The obvious way would be a money target like the Chinese who have low inflation. Money and credit excess last year could have warned them they were too loose and getting inflation wrong. Money and credit now points to falling inflation as it is tight in real terms.