The Telegraph

Interest rates won't rise this week - but you won't have to wait too long

Rate-setters need to pay more attention to ensuring medium-term stability having held rates at record low for seven years

Policy-makers at the Bank of England are getting closer to raising rates Photo: Reuters

By Roger Bootle

5:35PM GMT 06 Dec 2015

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After last week's **US employment figures**, it looks as if things are on course for a rise in American interest rates next week. Meanwhile, our own MPC will decide on rates here this Thursday.

It is widely believed that a rise in US interest rates brings an increase here, but this is wrong. It is true that, in the past, interest rates have tended to follow a similar path in most major economies. But not always. When rates did move in tandem it was primarily because major parts of the world were subject to similar economic forces at the same time. Over and above this, even when there were differences between economies, exchange rate considerations tended to encourage central banks to move in step with each other.

In both respects, things are rather different now. True, our economy is similar to America's in both structure and stage in the business cycle. But the UK is piggy-in-the-middle between the US and continental Europe, our largest export market. Although the eurozone has strengthened this year, it remains pretty weak. **Indeed, the ECB is still loosening monetary policy**, just as the **US Fed is about to tighten**.

US Federal Reserve Janet Yellan is expected to tighten monetary policy

Nor do the usual exchange rate considerations apply now. For a US rate rise to prompt a UK response, it would have to be because the sterling exchange rate weakens, possibly triggering a surge in inflation. Yet this is far from looking likely at present. Admittedly, the pound has been trending down against the dollar. But this is a reflection of the latter's overall strength.

The pound has been rising against the euro. Indeed, measured against a basket of the currencies of all the major countries with which the UK trades, it has become damagingly strong. Nor, of course, is inflation an immediate issue. On the contrary, it is running at about zero.

So what will determine the MPC's policy? According to the MPC's remit, the answer is surely "the inflation rate". **While inflation remains so low** – and it may not hit the 2pc target until 2018 – there is an argument that rates should remain at their current record low.

Yet the Bank of England's decisions should be forward-looking. The determinant of interest rate policy should not be where inflation is now but rather where it is likely to be at the point in the future when interest rate decisions now can have a bearing on the outcome. This is usually thought to be about two years' time. In two years from now, with the deflationary effects from lower oil and other commodity prices having fallen out of the annual comparison, the inflation rate should be approaching the 2pc target.


Crystal ball time: Decisions on the interest rate need to look into the future

But things aren't quite this simple. The stronger the growth of aggregate demand in the immediate future, the more likely it is that inflation will exceed the target in two years' time. Moreover, the MPC has a secondary objective, namely, subject to maintaining price stability, "to support the economic policy of Her Majesty's Government, including its objectives for growth and employment".

As usual, there are contradictory influences on aggregate demand. After the recent lull, fiscal tightening is set to resume. This will tend to restrain the growth of demand. Equally, the continued low growth of our major markets overseas will dampen the growth of our exports.

Nevertheless, there are also some positive factors. Perhaps the most important development is the growth of average real earnings after six years of decline. One consequence of inflation remaining low for a fair bit longer is that, even without any acceleration in the pace of nominal earnings increases, this increase in real earnings will continue. This should enable consumers to absorb the effects of fiscal tightening and underpin a pretty good increase in consumer spending. By the time that inflation rises significantly, the pace of nominal earnings increases should be picking up, thereby allowing real earnings to continue to grow.

Earnings should be increasing by the time inflation rises significantly Photo: Alamy

So far, so conventional. Monetary policy also has to take account of stability issues. Interest rates have been at this record low for almost seven years. There was always a danger that this policy – which I not only forecast but also supported – would cause distortions in both the real economy and financial markets. I judged this was a price worth paying to secure the economic recovery. I still believe that this was right.

But there are limits. The time is fast approaching when the balance of arguments switches towards correcting the distortions and paying more attention to ensuring medium-term stability. One of the biggest distortions is surely in the property market. You might readily believe that the potential vulnerability of the UK housing market is an argument in favour of moderating and/or delaying any rate rise.

Yet it also argues for beginning the process of raising interest rates sooner because, if rates stay below their normal, sustainable, level for longer, then house prices will rise still further. When interest rates eventually do go up they will rise faster and quite possibly further than they otherwise would. The danger is that this will cause a destabilising drop in house prices.

Leaving rates at current lows could destabilise the property market Photo: GETTY

This second consideration is gaining in importance. Although the Bank has other instruments at its disposal, the most important restraining influence on the overall state of the housing market is going to come from interest rates. Ideally, the Bank needs to follow a path of gentle rises in rates which will gradually reduce the rate of increase of house prices to near-zero.

So, stand by your beds. It won’t be this Thursday, but it won’t be that far into the new year before UK interest rates should start to rise.

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