# The inconstant MPC

**JOHN RATHBONE** AND **JOHN WALKER** PREDICT THAT MONEY SUPPLY FIGURES AND PRODUCER PRICE INDEXES WILL REPLACE WAGE INFLATION DATA IN DETERMINING THE BANK OF ENGLAND'S MONETARY STANCE.

The announcement in January that the consumer prices index (CPI) inflation measure had hit 3% the previous month was taken by the markets as justification for the 0.25% 'surprise' interest rate hike that the Bank of England's Monetary Policy Committee (MPC) had put in place the week before. Indeed, as the MPC would have had prior warning of the inflation level when determining its monetary stance, many economists decided that the CPI measure must have been the sole determinant for increasing rates in a month when the Bank does not publish its quarterly inflation report.

While the CPI inflation measure has retreated from this peak level in the following months – and in the process let Mervyn King, the Governor of the Bank, off the hook of having to write to the Chancellor to explain why inflation was more than 1% above its target level – it is a very small drop in comparison with what may be expected over the next six months. *Chart 1* shows the movement in the year-on-year CPI inflation figure over the past year and the movement in three-month Libor over the same period. As can be seen, the increase in short-term interest rates has roughly paralleled the upward movements in inflation over this period.

It is certain that, as the increases in energy costs drop out of the year-on-year index, the CPI inflation level will fall markedly. The question facing most forecasters is not whether the rate will fall, but how far and by when. Even the Bank's quarterly inflation report projects CPI inflation falling to 1.75% during the course of the rest of the year. Most economists are projecting a steeper reduction, with the 2% target being achieved by June and inflation falling to 1.5%, or even lower, after that.

By comparison, the financial markets are projecting, at the time of writing, that the base rate will increase at least once more before enjoying a very static period thereafter. This produces a very different expectation in terms of the relationship between inflation and short-term rates over the next 12 months from the previous period. *Chart 2* shows a comparison of a median forecast of CPI inflation over the course of the next year with the trading levels of the short sterling futures contracts traded on London International Financial Futures Exchange (Liffe).

**MARKET DIVERGENCE** The market is therefore expecting to see a divergence of 4.35% between prevailing short-term interest rates and the CPI inflation level towards the end of this year. This would be the highest level of real interest rates since 2001.

The obvious question emerges is why, if inflation is going to drop below its target range, will it not have any influence over short-term rates? The mantra from the MPC is that it manages monetary policy in terms of looking out over a two-year period. Hence, its median forecast, which is based on currently trading interest rate expectations, always returns to the 2% level, or very close to it.


## Executive summary

- **The Monetary Policy Committee is not inclined towards consistency and has a habit of choosing what may be regarded as a pressure point, only to drop it when it proves to have been an exaggerated concern.**
- **The market expects to see a divergence of 4.35% between prevailing short-term interest rates and the CPI inflation level towards the end of this year. If this happens, it will be the highest level of real interest rates since 2001.**
- **The consumer is starting to be less vigilant on price increases. Over the past decade every time that manufacturers and retailers have tried to increase prices by more than an amount justified by the inflation rate, consumers have gone on a buying strike.**


Accordingly, the MPC, while expecting CPI inflation to fall to 1.75%, expects it gradually to rise again, returning to 2% in two years' time.

The reasons the MPC will deploy to argue there is no case for a reduction in rates are likely to be wide-ranging. The MPC – and King in particular – is not inclined towards consistency and has the habit of choosing what may be regarded as a pressure point, only to drop it when it proves to have been an exaggerated concern.

A typical example is that of the fear that wage increases will spiral into 'second-round' inflation. Over the second half of last year, King consistently warned that the wage-setting process at the beginning of this year had to be restrained in order to control inflation. Indeed, some economists believe that the rate hike in January was primarily designed as a shot across the bows of those negotiating pay rounds, rather than as a reaction to the high inflation number.

While the wage round is not yet complete, it is already clear that the MPC's concerns over second-round inflation were considerably overdone. Indeed, at his recent testimony to the Treasury select committee, King noted that the pick-up in wage settlements was "less than what would cause us concern".

So if average earnings trends are fading as a key element in determining a change in monetary policy, what other indicators might grow in importance in shaping the MPC's thought processes? We suspect that the money supply figures and the producer price indices will come into much sharper focus over the course of the rest of the year.

**MONEY SUPPLY FIGURES** Apart from in the minds of a few die-hard monetarists, the money supply figures have fallen away over the past 20 years as a factor in setting interest rates. However, the recent rapid rise in money supply to the highest levels that have been seen in the past decade has started a review on whether current levels are

a portent for higher inflation in the future. While some members of the MPC are clearly far from convinced that money supply has any bearing on future inflation levels, the Governor has noted that "to ignore it as a potential medium-term influence could lead into tricky territory".

This seems ironic as the money supply figures were completely ignored when they were at lower levels. Nowhere in the MPC minutes does the low level of money supply get a mention as having an influence in maintaining inflation at low levels. However, as we have previously noted, consistency is not a virtue that comes easily to the MPC.

The other concern that the MPC has identified, particularly from the reports it receives from the Bank of England's agents around the country, is that the consumer is starting to be less vigilant on price increases. One of the major factors that has ensured inflation has remained at low levels over the past decade is that every time manufacturers and retailers have tried to increase prices by more than an amount justified by the inflation rate, consumers have gone on a buying strike. Backed up by cheap imports, this factor has ensured that core inflation has remained in negative territory for much of the past five years.

**CONSUMERS LESS VIGILANT** The MPC is clearly concerned that this situation will not continue and that the consumer is proving less vigilant in rejecting increased pricing. The resulting worry is that the reduction in the inflation rate caused by the removal of last year's energy cost increases will have only a fleeting effect and will be replaced by manufacturers and retailers taking advantage of the current very healthy level of growth in retail sales to pass on price increases and, at last, make them stick.

The monthly producer price input and output indices may become more influential economic statistics. While most economists have always regarded these figures, particularly at the output level, as providing a good indication of the inflationary pressures building up in the pipeline, they have seldom had much influence on the interest rate market over the past couple of years. We would expect this to change during the course of this year as the market reverts to giving greater credence to these statistics, and particularly to any widening between the input and output indices, which would

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imply a successful campaign to lift profit margins.

While the MPC will no doubt discourage the market from expecting a fall in the CPI inflation measure to automatically lead to lower interest rates, it may find this more difficult to achieve if it coincides with less than supportive economic data. A fall in inflation to below its target level combined with a reduction in the year-on-year retail sales levels or a hiccup in the rise of house prices will rapidly bring pressure on the MPC to stop searching for potential inflationary dangers around every corner and to concentrate on the realities with which it is confronted, rather than a less than perfect analysis of what might happen over the following couple of years. Even more likely is that a slowdown in the global economy, especially in the US, will import pressures that the MPC will find difficult to resist.

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**Chart 1.** CPI versus three-month Libor

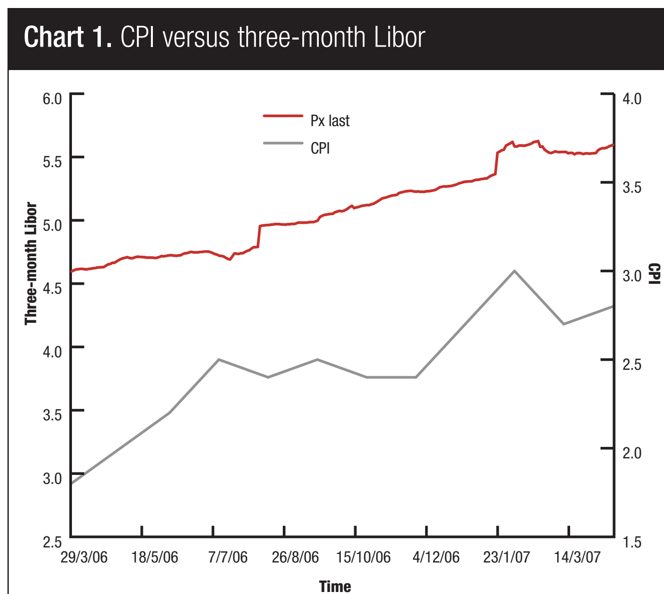


**Chart 2.** CPI forecast versus Liffe interest rates