NOT QUITE SO GLOOMY, PLEASE

JONATHAN LOYNES OF CAPITAL ECONOMICS BELIEVES THAT THE MONEY MARKETS' EXPECTATIONS OF HIGHER INTEREST RATES ARE NOT JUSTIFIED BY THE ACTUAL STATE OF THE ECONOMY. IT WOULD BE UNWISE TO PUSH RATES UP WHILE THE GLOBAL ECONOMY IS STILL IN THE RECOVERY POSITION.

Financial markets usually alter their views of the world fairly slowly, changing their minds gradually, and often grudgingly, only as the evidence before them becomes too strong to ignore. But every so often, the opposite happens. Market sentiment swings sharply with little apparent justification from the fundamental news on the economy, or at least not enough to explain the swings in markets.

The shift in market expectations for UK interest rates in the last few months has, in my opinion, been an example of the latter type of movement. Only a couple of months ago, money markets were discounting further reductions in rates this year from their already low level of 3.5%. In the space of a few weeks, however, there has been a dramatic change: markets are now pricing in higher interest rates by the end of the year. What's more, expectations for the likely path of interest rates stretching into the future have risen even further. Implied rates for the end of 2004, for example, have climbed by nearly 1.5% since July and now there are discount rates of around 4.75%, 1.25% above current levels. As the chart shows, rates are then expected to keep on rising to 5% and above.

Of course, these movements have not been totally without explanation. Back in the summer, the economic news was distinctly soft, and markets and policymakers alike were fretting about the dangers of deflation in the US and Europe. Since then, there have been signs of a pick-up in activity both at home and abroad, and deflation fears have subsided. Meanwhile, in contrast to the US Federal Reserve, which has gone out of its way to assure investors that interest rates are unlikely to rise in the foreseeable future, various members of the UK's Monetary Policy Committee (MPC) have helped to fuel the pessimism of the markets with a distinctly more hawkish tone to their comments.

JUSTIFIED AGRESSION? But while these developments have probably put paid to the chances of further cuts in UK interest rates – at least for now – I find it hard to believe that they justify the aggressive monetary tightening that money markets have priced in for the next year or two.

After all, while economic growth certainly looks to be accelerating, there is surely not a forecaster in the land who did not expect some sort of improvement on the lacklustre performance of the last few quarters. Indeed, it is notable that while market interest rates and bond yields have been rising sharply in the last few months, consensus expectations for GDP growth in the UK have barely changed: a pretty modest 1.8% for this year and 2.4% for next year. In other words, the sharp turnaround in interest-rate sentiment has not been supported by a marked change in expectations for the economy.

What's more, even if the economy sees stronger growth, there should, after three years of below-trend growth, be enough slack (or a big enough output gap, to use the jargon) to allow several years of rapid growth before the economy hits the buffers and inflation pressures begin to build. Admittedly, the recent upward revisions to the GDP data over the last few years have prompted some commentators to suggest that there is less slack in the economy than previously thought; but this makes little sense. What the revisions showed was that the economy grew more quickly than expected in real terms, yet this was accompanied by lower inflation at the whole economy level than we previously thought. So either there was more slack in the economy to begin with, or the trade-off between growth and inflation was better. Either way, this would seem to bode well for continued low inflation in the future.

Perhaps the strongest argument in support of the sharp rises in interest rates priced in by markets over the next year or so is that such action could ultimately prevent the economy from slumping into recession. Though the idea of higher interest rates helping to prevent recession sounds odd, it is a reflection of the growing concerns among some members of the MPC about the strength of household borrowing.

They argue that the longer low interest rates encourage households to keep taking on debt in order to help fund rapid increases in spending, the greater the danger that they will eventually over-extend themselves. A subsequent sharp downward adjustment in both borrowing and spending could have very damaging consequences for the overall economy, particularly if accompanied, as it surely would be, by a sharp downturn in the housing market. Better to attempt to limit the strength of borrowing now, they argue, than wait for it to collapse suddenly at some point in the future.

But while I certainly share those members' worries about the potential effects of the build-up of household debt, raising rates now, specifically to discourage households from borrowing, sounds to me a like a case of shutting the stable door after the horse has disappeared over the horizon. After all, debt has already climbed to record levels as a share of income.

What's more, such a strategy could prove to be very dangerous if it succeeded in pushing expectations of the likely path interest rates could take in the future even higher. The MPC could end up simply bringing forward the very downward adjustment it would be seeking to avoid. Needless to say, these dangers are all the more grave at a time when the economy is still heavily dependent on household spending as the main source of upward momentum.

Thankfully, I don't think that this suggestion will actually become policy. Those members seriously considering it seem to be firmly in a minority, and none has yet felt strongly enough to vote for higher rates. What's more, I suspect that the need for the MPC to take matters into its own hands will be reduced by a natural slowdown in the pace of spending and borrowing over the coming months, as households respond to weaker income growth and a slowdown in the housing market.

Indeed, the recent revisions to the GDP figures helped in this regard by presenting rather stronger evidence that spending has already started to slow. They left household spending growing at an average quarterly rate of just 0.25% in the first half of this year, the weakest performance over two quarters for eight years.

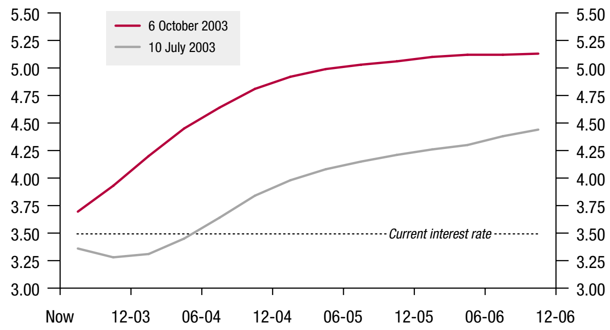
None of this is to suggest that interest rates will definitely not rise in the foreseeable future. One possibility is that the MPC will decide to reverse the widely unexpected reduction from 3.75% to 3.5% in July, which it always described as "precautionary". Provided that the markets, and of course, borrowers, perceived this to be an isolated move, this might take some of the steam out of borrowing without triggering a major downward adjustment. What's more, it is possible that the economic data simply strengthens by more than anyone is currently expecting.

A STEP TOO FAR? But I doubt whether, even under these circumstances, interest rates will rise as sharply over the coming year as money markets are currently discounting. The UK already has the highest interest rates in the developed world. To push them up aggressively when the global economy is still recovering from the biggest financial bubble in history – and when other central banks will be keeping rates on hold until they are absolutely sure recovery is under way – would surely be taking the MPC's pre-emptive policy unwisely far.

If nothing else, increasing the already substantial gap between UK rates and those elsewhere would risk reversing, or at least halting,

FIGURE 1

MARKET EXPECTATIONS FOR UK INTEREST RATES



what has been one of the most favourable developments of the last year or so, the drop in the sterling exchange rate. This in turn would risk preventing the much-needed re-balancing of the economy away from domestic demand back towards the external sectors.

The upshot is that I think that market interest-rate expectations, and probably yields at the short end of the bond market, are likely to reverse some of the sharp rises seen in the last few months. My own view is that official interest rates won't increase until the third quarter of next year, and will end 2004 at just 4%, some 0.75% below the rate currently priced into markets. If this sounds like a bold call, let me remind you of a fact that I have pointed out in this column before – that market interest rate expectations have proved to be too high in 12 of the last 14 years. On that basis, believing the markets is the bolder call.

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