The Bank seeks to slow the economy some more

As I have reported before, the Bank of England has been tightening money conditions for sometime because it wishes to slow the UK economy. It has recently increased the base rate to 0.5%. It used macro prudential policy to seek to rein in consumer credit. It has been particularly successful at reducing car loans and it refers to this in the latest Inflation Report. The government has also been active in cutting car demand with its high VED taxes on dearer vehicles introduced last spring and its attack on diesels. Mortgages are a bit dearer and higher Stamp duties and BTL taxes have also hit the housing market.

This month the Bank ends the Term Funding Scheme for the commercial banks, a scheme designed to ease credit conditions a bit. Now in this Report we hear that the Bank wants to get back to the inflation target faster, and expects to have to raise rates again to do so. Meanwhile there has also been an additional monetary tightening through the increase in the exchange rate in recent months. So why is the Bank doing this when most people want to see a bit more growth?

The Bank has gone back to its idea that the UK economy can only grow at a fixed pace, and if it starts to grow faster than the trend increase in capacity it will cause more rapid inflation. The Governor himself has questioned this theory in a good lecture he gave pointing out that if you are capacity constrained then you can simply import more, keeping prices down. You can also invite in more workers from abroad, keeping wages down as has been happening on a large scale in recent years. It is difficult to know why the Bank thinks the UK trend growth can now only manage 1.5%, and why they ignore the sensible thoughts of the Governor on the impact of the global economy on prices and wages. They also need to ask how flexible the economy is to scale up capacity. We see new capacity going in and there is plenty of corporate cashflow to invest. Many companies are expanding capacity considerably by continuing to recruit extra staff.

It is also curious that they seem to have an asymmetric and distorted view of sterling and its role in inflation. Apparently a recent devaluation is causing most of the price rises we are seeing, but the more recent strengthening of sterling will not redress this sufficiently. They tell us sterling is 15-20% down on the levels of November 2015. That was of course a peak level. Sterling on the trade weighted is currently around the levels it was at for a long period from 2009 to 2014. Against the dollar is almost back to the pre referendum vote level. If you want to see a big devaluation which did not reverse you need to go back to 2008-9 when sterling was badly damaged by the banking crisis. That devaluation did not generate as much inflation as some expected.

The Bank claims that Brexit uncertainty is a big factor in the UK economic performance. There is precious little evidence to support that. The Bank, after all, has had again to scale up its growth forecast for the UK, which paradoxically gives it a better excuse to tighten money more. Consumption remains the main driver of the UK economy. I don’t meet lots of people telling me they have cut back on their shopping because of Brexit. If, as the Bank now thinks, wages are going to pick up a bit that should be good news for consumption and therefore for economic activity.