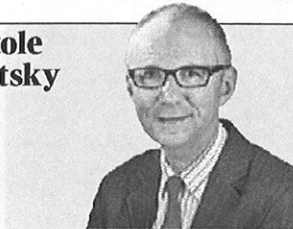


Mervyn King panics and recession beckons

The Governor has signalled that interest rates will rise. His obsession with inflation will kill growth

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If you think that Britain is at risk of a double-dip recession, think again. As of today, a relapse into recession is not just a risk, it is a near-certainty. Contrary to my earlier expectations, it now looks like the Bank of England will capitulate to City analysts who view a brief period of 4 per cent inflation as a national crisis and will start raising interest rates within the next few months.

The giveaway was the key phrase in Mervyn King's open letter to the Chancellor that was published an hour after the 4 per cent figure was released. "The Monetary Policy Committee's central judgment, under the assumption that Bank Rate increases in line with market expectations [my italics], remains that ... inflation will fall back" in two to three years' time to around its target level of 2 per cent. Cutting through the bureaucratic jargon, the meaning of this phrase, one which the Governor has never used in an open letter, was clear.

Market expectations can be precisely gauged in the City's interest rate futures, and they point to a first rate increase in March, April or May, followed by two more rate hikes in the autumn. It now seems inevitable that

the Governor, who had previously opposed any interest rate increase, would vote to validate the market's expectation of higher rates.

To make matters worse, Mr King's decision to adopt this tough posture is likely to encourage market speculators to expect even higher rates — as indeed they already had by yesterday afternoon. This will in turn put even more pressure on the Bank to keep tightening monetary policy to satisfy the City's bond market vigilantes. As a result, a vicious circle of higher interest rates and pressure for still-higher rates is likely to continue until a relapse into recession or a new financial crisis has become unavoidable.

Unless Mr King eats his words at his quarterly press conference this

The VAT increase was the main cause of the inflation overshoot

morning, the Bank's apparent panic in the face of what it previously described as a temporary spike in inflation will dash hopes that stronger private spending would compensate for the reductions in economic activity caused by public spending cuts and tax hikes. As a result, the coalition's economic and budgetary strategy will have to be called into question.

This strategy rested on offsetting job and income losses in the private sector, resulting from unprecedented reductions in public spending and

borrowing, with an equally unprecedented policy of monetary expansion and near-zero interest rates.

When Britain's recovery showed signs of flagging last year under the pressure of the first round of spending cuts and tax hikes introduced by Labour, Mr King repeatedly reassured the new Government, the business community and the public that the Treasury could take even more deflationary measures without worrying about the economic impact. For example, he told the Trades Union Congress in October that provided there was a "credible plan to reduce the deficit", the Bank had virtually unlimited capacity to revive and sustain economic growth with low interest rates and monetary expansion.

So why has Mr King apparently changed his mind? The obvious reason is that inflation at 4 per cent is already double the Bank's 2 per cent target and is likely to rise even further. Looking beneath the headline, however, it turns out that the overshoot of inflation has been caused almost entirely by the VAT increase introduced last month by the Chancellor with Mr King's strong support.

Excluding the effects of indirect taxes, the consumer prices index in January was only 2.4 per cent higher than the year before — and has been below 3 per cent since summer 2009.

In the past, the Bank has stressed that it would look beyond policy-induced aberrations in the CPI unless there was evidence that temporary factors, such as VAT hikes, were becoming embedded in wage inflation.

Wage costs account for the great bulk of domestically generated inflation that monetary policy is capable of controlling — and unless wages accelerate, there is no possibility in an advanced, service-based economy that inflation will get out of control. In Britain today, the possibility of a wage-price spiral is implausible, what with waves of redundancies about to hit the public sector, with pay for remaining government employees subject to cuts or freezes and with

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growth in the private economy slowing almost to a standstill.

Why, then, is the Bank so worried that it is prepared to jeopardise a flagging recovery? It has clearly been stung by media and City accusations about "going soft" on inflation and continually missing its targets. It may be that the MPC has decided that enough is enough, and intends to draw a line in the sand.

While taking a symbolic stand in defence of the Bank's reputation may sound vain and self-important, especially if the consequence is the loss of business and jobs, Mr King can appeal to academic economics.

According to the theory of rational expectations — the prevailing orthodoxy since monetarism became fashionable in the late 1970s — a

central bank must convince the public that it will do whatever is necessary to stabilise inflation regardless of sacrifices to jobs or growth. If people truly believe that the central bank is run by anti-inflation fanatics, then prices and wages will remain stable and there will be no need to suppress economic growth. But woe betide the nation that treats central banks like other public officials, who must balance trade-offs between desirable but sometimes conflicting objectives, such as price stability and employment.

The bizarre view that central bankers must behave in an obsessive-compulsive manner that in any other profession would be deemed clinically insane has never been supported by empirical evidence. Its intellectual foundations have been exploded by the financial crisis. Yet this idea continues to hold sway in most central banks. Only the US Federal Reserve publicly acknowledges its obligation to maximise employment as well as to keep inflation under control.

If Mr King sticks to his guns at today's press conference and presents himself as an inflation obsessive determined to raise interest rates even as the economy slides towards recession, the contrast between British austerity and American laxity, already evident in budgetary policies, will be extended into monetary policy. The controlled transatlantic experiment in Keynesian versus monetarist policies will become ever more revealing. The smart money will be on Obama-Bernanke rather than Cameron-King.