Courage, Mervyn. Keep interest rates down

The economy is fragile and confidence is jittery. It would be folly to try to beat price rises out of the system

Anatole Kaletsky

Dear Mervyn,
I do not usually write open letters, especially to people whom I have known socially for longer than I care to remember. But as you so evidently enjoy your open correspondence with George Osborne, I thought you might not mind if I joined in with some unsolicited advice.

As the Bank of England's Governor, you know better than I do that the meeting of the Monetary Policy Committee today and tomorrow is due to take the most important — and contentious — decision since the immediate aftermath of the 2008 crisis: whether to raise interest rates. During the crisis, the MPC's wise judgments prevented an infinitely worse outcome than the moderate recession that Britain suffered in 2009.

Contrary to popular belief and fashionable media cynicism, the Bank of England has had a superb record in hitting its targets. Since 1997, when the Bank was instructed by Parliament to keep consumer price inflation at 2 per cent in the medium term, the average annual increase in the CPI has been 1.92 per cent.

Even today, in the midst of all the Middle Eastern upheavals, the reason why inflation is as high as 4.4 per cent is because of Mr Osborne's VAT increase. The latest index of "inflation at constant taxes" — which excludes the effects of tax rises such as VAT and fuel duty on prices — is 2.7 per cent, well within the 1 per cent margin for error set by Parliament. This simple statistic, as measured by the Office for National Statistics, incorporates every element in the consumer prices index. Why doesn't the Bank just emphasise this figure, instead of arguing that inflation somehow doesn't matter if it is caused by oil prices or currency movements or Chinese wages?

This reminds me of a schoolboy who arrives late at school and instead of simply saying that he missed the bus,

Inflation is so high because of George Osborne's VAT rise

offers endless excuses: the bus came late, then it ran over a cat. Credibility can be inversely proportional to the number of explanations.

My first piece of unsolicited advice therefore is that you think more carefully about how you guide public expectations. The Bank has a convincing case to make about fulfilling its mandate. And you have a well-deserved reputation as a brilliant communicator — by far the best among the world's central bankers. Why then do the public blame monetary policy for above-target inflation instead of the coalition's tax policy? And why did you confuse the markets last month by implying in your last letter to Mr Osborne that a rate rise was almost inevitable, only to say the opposite at your next press conference? In short, why has the Bank's credibility sunk so low?

Credibility brings me to the next, more substantial, reason for writing to you. The European Central Bank has announced its plan to raise interest rates tomorrow and some members of the MPC want to do the same. If it votes to do this, the Bank of England's monetary credibility will be severely threatened. A rate rise now — even the expectation of one — would hit consumer confidence, which is already collapsing and would threaten the tentative recovery in exports by boosting the pound. If this hits the economy, as is likely, the MPC will be too embarrassed to resume the quantitative easing that was so successful in 2009 and that the US Federal Reserve used last autumn to pull the US economy out of a temporary slowdown.

Suppose, on the other hand, that you can persuade the MPC to move back into neutral mode. There will then be plenty of time to review monetary policy in May, June and beyond. By that time, inflation may well have peaked, as suggested already by recent figures on food prices. The energy tax rises of last April will be replaced in annual comparisons by reductions in the Budget. And Andrew Sentance, the most hawkish MPC member, will retire after the May meeting. As a result, market expectations of a rate increase will immediately subside.

In short, if the MPC avoids a rate increase this month or next, the expectations of a rate increase created by last month's poor communications could be dispelled completely. The MPC will then be free either to tighten monetary policy or to ease it, if that is what a weakening economy requires.

Which leads me to the third and most important reason for writing. The

Even a small jolt to business confidence could bring recession

Bank must reflect on its responsibilities even more seriously than usual, because Britain is at greater risk of a genuine disaster than at any time since you and Gordon Brown saved the financial system in October 2008.

Given the fragility of the post-Lehman recovery and the unprecedented fiscal contraction that begins this month, even a small jolt to consumer and business confidence could push the economy into recession. Indeed, consumer confidence has already dropped to its level of March 2009, house prices have been falling since the autumn and retailers report that spending "hit a brick wall" in mid-January — it could fall off a cliff once consumers' pay and benefit packets are depleted in May.

If the Government is reducing its spending, consumers and businesses will have to borrow and spend more to stop the economy sliding into recession. And with after-tax incomes falling, the only way the public and businesses can spend more is by borrowing or dipping into savings. The coalition, the media and the public do not seem to understand this — but you certainly do, as does the Office for Budget Responsibility, which has quietly assumed a substantial reduction in consumer saving in order to make the fiscal arithmetic add up.

You also know that the only reliable way to persuade people to reduce savings is to keep interest rates exceptionally low for an exceptionally long time. If you do not do this, the Government's deficit reduction plans will become arithmetically impossible and public debts will spiral out of control. All the sacrifices imposed by the Government will seem in vain and the coalition will crumble.

Your choice is therefore quite clear. Do you persuade the MPC to hold its ground on monetary policy and explain to the public that the threat facing Britain today is not inflation, but recession, thereby risking a few weeks of media ridicule for being "soft on inflation", or even a "wimp"? Or do you risk Britain's future to win some macho headlines about "courage" and "toughness"?

I think I know which approach you would favour. But can you try even harder than usual to control the dangerously message sent out by your swaggering colleagues on the MPC?

Yours, Anatole