



UK Inflation

Q: Why did the Bank of England Keep Interest Rates Unchanged?

13th May 2008 - Annual Inflation Surges to 3% in April

“Annual UK inflation rose by 0.5% to 3% in April in what is the sharpest single month increase since 2002”

A: Because they knew inflation was back!

Even though the answer was pretty clear many were left scratching their heads as to why the Bank of England left UK interest rates unchanged at 5.0% following their last meeting. Firstly US rates have been

cut several times this year to ward off the possibility of economic recession, yet UK rates remain high in contrast. Secondly the UK housing market is still in decline;

Mortgage lending to home buyers hit its lowest level for 33 years in the first quarter

Northern Rock reported mortgage arrears doubled in the first quarter

RIC survey reported 82% of estate agents had seen a drop in prices; worst since 1978

So why did the BOE not cut rates further? There are two reasons; (1) they expected their “emergency” talks with Britain’s lending institutions to lead to a fall in the lending rates offered to consumers (which it hasn’t) and (2) it knew inflation was on the rise, again!

Without the benefits of foresight attributed to the MPC, analysts had been expecting a modest rise from March’s level but not the 0.8% announced by the Office for National Statistics, the highest since record begun in 2002. Electricity, housing, water and gas bills along with other fuels saw a 5.4% increase during April. Other major contributors in the April CPI data rise included a 6.6% hike in food and soft drinks in April, the sharpest increase since records began in January 1997.

The Bank of England is charged with keeping CPI inflation at 2% and if the rate increases any higher above 3% Bank governor Mervyn King would be forced to write an explanatory letter to the Chancellor of the Exchequer Alistair Darling, his second in about 18 months since the Bank assumed monetary policy more than 10 years ago.

Given that utility companies and retailers are now passing on the cost of higher raw materials and production costs, neither of which look set to fall meaningfully soon, inflation may creep above the 3% line in the sand, certainly slowing the rate at which interest rates fall. However, changes in interest rate do not directly affect food and energy costs meaning that the MPC may prefer to suffer some pain from high headline inflation figures and support the strength of underlying economy than see the UK descend into recession.

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