

Untitled

Interest rates 'could rise sharply early next year'

Interest rates could start to rise early next year – and by more than in previous cycles, according to an economist at a City fund manager.

By Richard Evans

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The Bank of England targets the inflation rate two years in the future Photo: DANIEL JONES
This would cause a large rise in mortgage repayments for borrowers on tracker and other variable-rate mortgages, some of whom are staying afloat financially only because interest rates are currently at an all-time low.

In a blog entitled “Could UK rates rise in early 2010?”, Simon Ward of Henderson New Star said the Bank of England’s projections for inflation in two years’ time could be at the top end of their historic range at 2.5pc. The Bank bases its interest rate decisions on inflation expectations about two years in the future.

This high level of expected inflation implies that the Bank might have to raise rates to bring price rises back down towards the target of 2pc. The other means of tightening policy, a reversal of “quantitative easing” or money creation, is “off the agenda”, Mr Ward said, because of the likely effect on the cost of government borrowing.

“An eventual withdrawal of monetary stimulus is likely to take the form of a rise in Bank Rate rather than a reversal of quantitative easing,” he wrote. “Given the historically low starting level [of interest rates], rises in Bank Rate, when they begin, could be larger than in the initial stages of prior cycles.”

The two-year-ahead forecast for inflation is now above the target, at 2.17pc, Mr Ward pointed out. “This is the first positive deviation since last August and the largest since August 2007 – the MPC [monetary policy committee] last raised Bank Rate in July 2007.”

He said the committee’s decision to adopt a looser policy than warranted by its projections appeared to reflect a judgement that the economic costs of inflation undershooting the target would exceed those of an overshoot. “It has, in effect, taken out temporary insurance against worse-than-expected outcomes.

“The emphasis, however, is on ‘temporary’, since such an approach risks damaging inflation-fighting credibility.”