The Bank of England, interest rates and the UK economy

Michael McMahon
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The Bank of England raised interest rates for the first time in over 10 years on Thursday 2 November. This decision was unsurprising given that the Bank had signalled its likely intentions well in advance. And yet it doesn't feel like there is a huge amount of strong momentum in the economy that we might typically associate with a rising interest rates. Here I explore five questions regarding the Bank of England's policy.

What did the Bank of England see that made them increase interest rates?

The first place to look to answer this question is to the Monetary Policy Committee (MPC) themselves. In the monetary policy statement and the release of the November Inflation Report (IR) at the same time, there were three key messages:[1]

- **High inflation:** At 3%, the rate of inflation (the % change in the level of prices) is above the Bank's 2% target.
- **High employment:** 1 million more people in work since 2015 and unemployment is at a 42-year low.
- **Economic growth**: The economy growing at 1.5% per year is "around its new lower speed limit".

The inflation rate is above the MPC's target of 2% (set by the Treasury for the MPC to achieve). While it remains *just* within the acceptable range implied by their target (1-3%), inflation is at the top end of the range and the typical response to bring high inflation back under control is to increase interest rates. In that respect, the rate rise looks standard.

However, this is not a standard inflation reading. A main cause of the increase in inflation is "the fall in the pound following the Brexit vote." A weaker Sterling exchange rate means that a €100 or $100 item that is bought in foreign currency from abroad immediately costs more in Sterling terms. Retailers will pass on the higher costs to consumers and that increases consumer inflation.

[1] November Inflation Report 2017 available at: http://www.bankofengland.co.uk/publications/Pages/inflationreport/2017/nov.aspx

So why did the Bank now consider that higher inflation was a problem? Could they have waited? The November IR points to what they call key judgement 4: "significant upward pressure on inflation from import and energy prices eases over the forecast period and domestic inflationary pressures build". The specific channel is through pressures from the labour market. The IR discusses "some tentative signs of wage growth picking up, especially for new recruits" and an expectation that higher employment and low unemployment should "feed through into higher average pay growth over time".

While higher employment is good for society, the Bank's concern will be that the labour market will become difficult for firms to higher and so staff will be able to demand higher wages to stay or attract offers of higher wages to move. These cost increases will be passed on to consumers in the form of higher prices.

This channel leading to inflation is not particularly controversial but the extent of the building wage pressures is. The MPC acknowledge this uncertainty when they write: "But there is still uncertainty about how responsive pay will be to an increasingly tight labour market. It is possible, for example, that pressure in the labour market at a time of above-target inflation feeds through to wage growth more quickly than assumed.

In the other direction, uncertainty about the outlook for demand and profitability could weigh on companies' pay decisions or workers' willingness to search for a new role." But, in fact, a year ago in November 2016 the Bank took the view that wage growth was "still well below pre-crisis average rates, despite unemployment falling back to around its pre-crisis level over recent years". The November 2017 IR's Table 4.B reports little evidence of the growing wage pressures.

One other message stressed by the Bank is that there is a new normal in terms of the sustainable, non-inflationary, growth of the economy. Relatively recently we considered around 2.5% growth normal. The Bank now assesses that 1.5% is normal, at least for the next few years. The persistent problem is weak productivity growth. Any building wage pressures that occur alongside more favourable developments in productivity would negate the need to pass on higher costs in the form of price rises.

I believe that the MPC could have waited to increase interest rates. Two deputy Governors voted against the rate increase and I would have joined them especially if they were making the decision in total isolation from past messages they had sent.

But in defence of the move, it is small. 0.25% to 0.5% is not large enough to create massive aggregate effects especially as many mortgages are fixed. One concern is distributional; already stretched households are likely to be the ones who couldn't re-mortgage and are on Standard Variable Rate (SVR) rates which are already much higher and will go up. But the Bank cannot use monetary policy to address distributional issues. Moreover, this move reverses the (equally small) cut last year and monetary policy remains extremely accommodative - adjusted for inflation, interest rates are still very low.

Why did the Bank decide to signal the move in advance?

One thing that may have pushed me toward going through with the small increase is the fact that it had been so signalled. The surprise was not in November when they moved but rather was over the last few months when the Bank suddenly started leaning toward an imminent rate rise.

To see how much the market was not anticipating this change in view, consider the comment by Goldman Sach's Huw Pill at the end of July 2017:[2] "In the UK, we continue to expect consumer spending to weaken further, owing to the squeeze on household incomes stemming from above-target inflation.

This weakening would cause the Bank of England to hold off rate hikes until late 2018." Following its September meeting, markets expected that the MPC was likely to raise interest rates fairly imminently with November 2 being the most likely first hike (85% likely initially).

Communication is a powerful policy tool and can be shown to influence interest rates even at much longer horizons.[3] Markets learn how monetary policy will be adjusted and market interest rates start to adjust in advance of any policy action. Given how long it had been since the Bank increased interest rates, and given how little the markets were expecting the Bank to increase interest rates, the Bank felt it appropriate to signal the move in advance.

Of course, the ultimate decisions must be taken at the official meetings but if members are starting to lean toward raising rates then it makes sense to make this known so as to avoid excess volatility when the change is announced. Former Governor, Lord King, would speak about making sure that monetary policy was boring and a sudden surprise increase would not have fit with this unofficial objective.

Perhaps the MPC were expecting to see clearer evidence of growth in wage pressures? Then it makes sense to signal that you intend to react quickly to the signs of wage pressure. The standard line of central bankers is that the decision would be dependent on the data.

And it should be ok to change your mind. There might be some market volatility if you signal something and do not deliver. But if the data doesn't support the position, and given the MPC's objective is to select the correct interest rate to deliver inflation around the target, then such volatility should generally be accepted.

[2] "European Economics Analyst: The European economy — A summer stock-take", 27 July 2017.
[3] My own recent work shows the important effects of central bank information signals – see Hansen, Hubert and McMahon (2017) and Hansen, McMahon and Tong (2017)

But the Bank had been previously criticised for delivering mixed messages in 2014. Governor Carney was accused of acting like an “unreliable boyfriend” by MP Pat McFadden. The Bank had suggested rates wouldn’t rise until 2016 but then suggested they *could* go up in late 2014 or early 2015. (Interestingly part of the reason for the suggested sooner increase in rates was that wage pressures were expected to take hold in the coming months.)

Was there a concern this month that, if they did not go through with the rate increase this time, they would reduce their credibility and weaken the potency of their future communication?

Given that monetary policy is still highly accommodative and the impact of the change is small, and given my view that communication is an important aspect of central bank policy, I can see an argument for a small increase to protect from further damage to communication policy. But it simply shifts the bigger question back to why they signalled so strongly in advance of the November meeting?

Why did markets react in the ‘wrong way’ to the interest rate increase?

One interesting part of the market reaction to the change is that markets were disappointed. The release of the decision and the IR actually led markets to push out their beliefs of when rates would increase next. They expected to see that the MPC had much more information on the growing inflationary pressures and they didn’t get the amount of evidence that they expected.

One place that this is apparent is in the exchange rate. The Pound Sterling exchange rate appreciated versus the euro and dollar as the meeting grew near. This is what you would expect if markets were increasingly convinced that UK interest rates would be relatively higher going forward. On the announcement and the release of information on November 2, Sterling started to depreciate again.

Should we expect to see further interest rate increases in the coming months?

The bottom line is no. And I think most people studying these things agree with that answer. It certainly is not sensible to worry about interest rates suddenly rising again to levels like 5% or 6% as they were before the financial crisis. As alluded to above, monetary policy is set dependent on the data. It is “endogenously determined” in the language of monetary policy wonks. In other words, the economy will have to improve massively and quickly for interest rates to be increased to those sorts of levels.

If that happens, then the economy, and the rest of the world, will have to be doing incredibly well (very high growth driven and accompanied by marked increases in wages even after inflation). So, the economy would be doing very well and, even then, the MPC would move over a period of many months rather than suddenly increasing the interest rate. The Bank has always spoken that rate increases would be “limited” and “gradual”.

At the time of the decision on November 2nd, markets were expecting only two further rate rises in the next three years. The November IR, however, suggests that markets were under predicting the necessary monetary tightening. The MPC inflation forecast assumes that the market is right and under this scenario, the most likely forecast outcome is that CPI inflation will be above target at the end of the forecast horizon suggesting more interest rate increases will be necessary. But markets missed this message. Perhaps they remain sceptical about the building wage pressures.

Why is the Bank trying to communicate beyond its usual audience of financial market participants and journalists?

This month the Bank of England launched a new broader-interest version of its quarterly Inflation Report aimed at speaking to a less-specialist audience. In fact, the bullet points of the key messages from the November IR discussed above actually come from this new summary.[4] There are a few different reasons to try to broaden the audience for the key messages in the Inflation Report.

Here I suggest four:

1. Household actions matter and they also need to form sensible expectations
2. The clearer messaging may help the media and financial market participants to also understand the message.
3. It may help to build the publics' confidence in the institution.
4. It may open a dialogue that can facilitate the flow of information from the general public to the central bank.

Now whether these new approaches give rise to significant gains along any of these dimensions remains to be seen. But while many central banks engage in a variety of ways with the public, the Bank of England has taken these first steps to target communication at the general public.

[4] www.inflationreport.co.uk is the new Inflation Report website which carries the summary material designed for a broader, less specialist, audience.

About the author

Michael McMahon is a Professor of Economics at the University of Oxford, and a Fellow of St Hugh's College. He is also the Director for Impact at CAGE. A macroeconomist, his interests lie in study of fiscal policy, business cycles, monetary economics, inventories and applied econometrics. Recently, together with Stephen Hansen, he has written a series of papers examining the way monetary policy is made and how institutional design features of central banks and their monetary policy committees influence the decisions. Much of his recent research uses the tools of computational linguistics to understand communication and deliberation in central banks. Professor McMahon's research has been published in many top journals including the Quarterly Journal of Economics, the Review of Economic Studies, the Journal of Monetary Economics, the Review of Economics and Statistics, the Journal of International Economics and the Journal of Applied Econometrics.

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