

What goes down must come up

The Bank of England becomes the first major central bank to raise rates but impact will be small with fiscal policy key to Omicron response

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The Bank of England performed a 'bait and switch' by not raising rates in November when many people expected they would, but then raising them today when many thought the rise of Omicron would mean that they would wait to see the impact of the new wave. Many commentators have focussed on the high *current* level of inflation as a key reason for raising rates. But the truth is that this is driven by global factors which the Bank cannot control. Instead, the key reason for the rate rise is the tightness of the labour market and the worry that this will lead to more sustained inflation in future, for example by increasing expectations of future inflation. While a series of interest rate rises would slow the economy significantly, today's rate rise – at just 0.15 percentage points – will have a limited impact on the overall economic outlook. Instead, as has been the case through much of the pandemic, fiscal policy remains the main 'game in town', so it will be down to the Chancellor to provide the much-needed support for the sectors that will be hit by the large rise in Omicron cases.

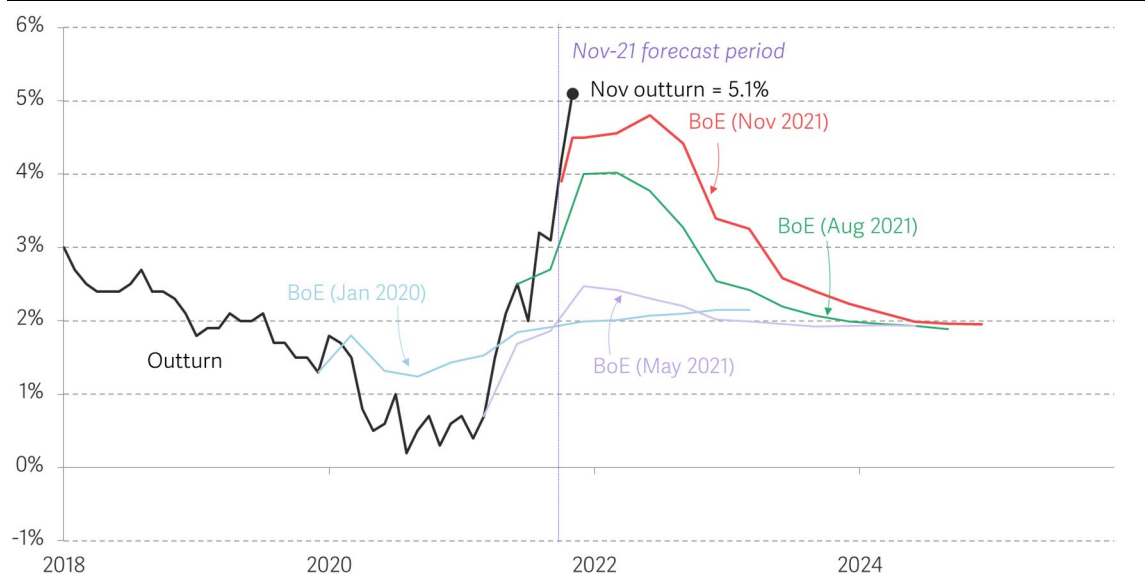
Today the Bank of England's Monetary Policy Committee (MPC) raised its policy rate from all-time lows of 0.1 per cent to 0.25 per cent. In end the timing was something of a surprise with many expecting a rate rise last month; and the rise of the Omicron variant seemingly providing a rationale for waiting this month (see [this speech](#) by MPC member Michael Saunders for that case). In doing so the Bank of England became the first of the world's major central banks to raise rates. In this Spotlight we look at the reasons for doing so, and the impact on families.

Inflationary pressures in the pipeline trigger tighter policy

Current high levels of inflation will make the Bank of England uneasy but there is little they can do to address its underlying causes. As Figure 1 shows, inflation has surprised to the upside this year with the MPC now saying that it is set to peak at around 6 per cent in April next year. If realised, that would be the highest inflation rate in 30 years. Such high rates are a problem not least because they reduce families' spending power. But they are also

uncomfortable for the MPC given they represent a large deviation from its 2 per cent inflation target. That said, current above-target inflation almost entirely reflects normalising energy prices and global goods prices that are being pushed up by supply-chain problems in world markets (see Chart 2 in [this speech](#) by Bank of England Deputy, Ben Broadbent). Neither of these factors will be helped noticeably by raising rates. Indeed, for the Bank to try to bring inflation down in the near term would simply result in derailing the economy given the time it takes for interest rate rises to take full effect (normally thought to be 18 months or so).

Figure 1 **The Bank of England has raised its forecast for inflation further**
Bank of England and OBR projections for CPI inflation (per cent): UK



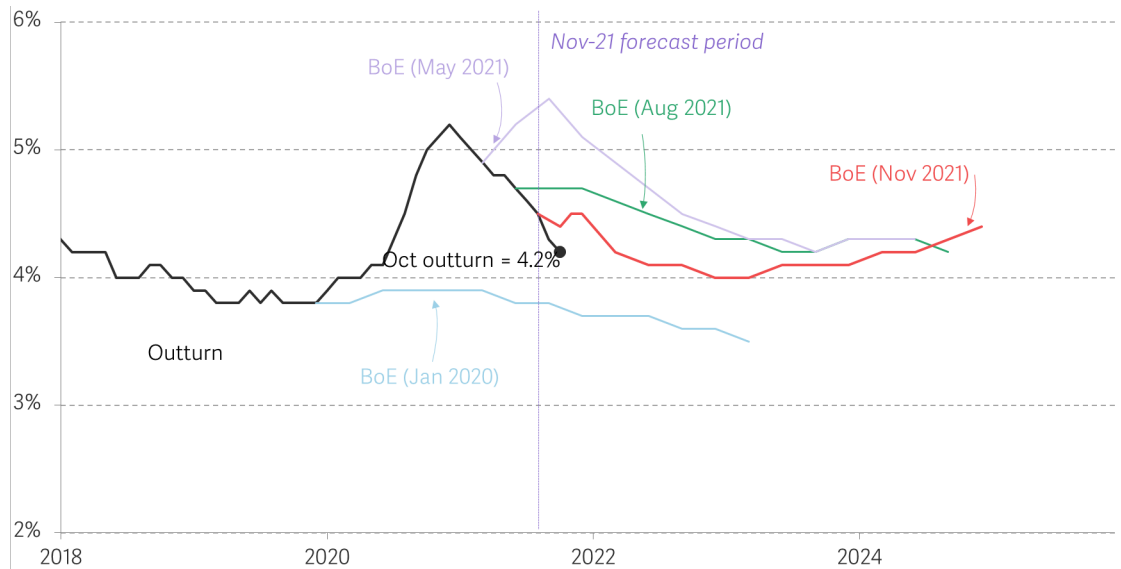
Source: Bank of England, Monetary Policy Report, various & ONS, Consumer price inflation.

Instead the Bank is worried about inflation coming through the pipeline. Here the key source of sustained domestic inflation is the labour market where the news in recent months has been very positive with the success of the Government's furlough scheme limiting the impact of the pandemic in terms of rising overall unemployment. Unemployment has repeatedly surprised to the downside during the pandemic (Figure 2). In November, the MPC said that the key uncertainty it faced at the time was the impact of the end of the Job Retention Scheme. Since then, unemployment has fallen further, with the rate in the three months to October falling to just 4.2 per cent. While the labour market recovery still has further to run, the Bank is clear that it believes the recovery so far is consistent with it becoming a building source of inflationary pressure and so supports the case for a gradual rise in interest rates.

The other key indicator for the Bank is inflation expectations. This is important because if families and firms expect higher inflation in future, workers will try to bargain for higher wages and firms will set higher prices. In this way, higher inflation expectations can become self-fulfilling and could mean that the Bank has to raise rates by even more in the future. In

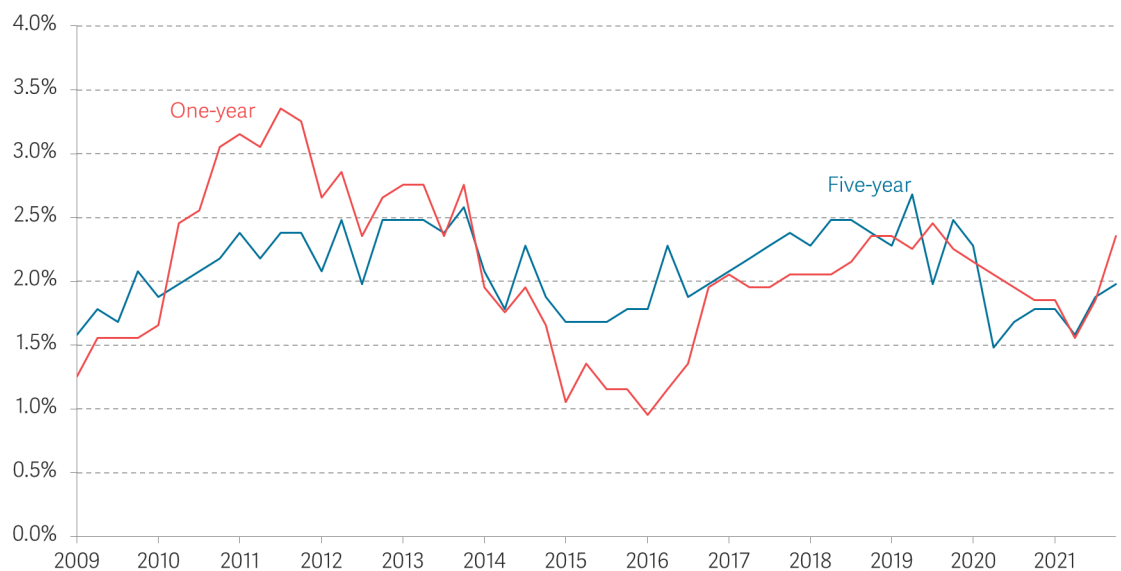
this context, the Bank is worried that a number of measures of inflation expectations have risen in recent months. For example, as shown in Figure 3, short- and medium-term expectations from the Bank’s own Kantar Inflation Attitudes Survey have risen through the course of this year, although they remain close to pre-pandemic levels.

Figure 2 **The labour market has tightened significantly in recent months**
16+ unemployment rate, outturns and successive Bank of England forecasts: UK



Source: RF analysis of ONS & Bank of England, Monetary Policy Report, various.

Figure 3 **Household inflation expectations have risen but by less than inflation**
Median household expectation for changes in shop prices over the next year, or in five years’ time: UK



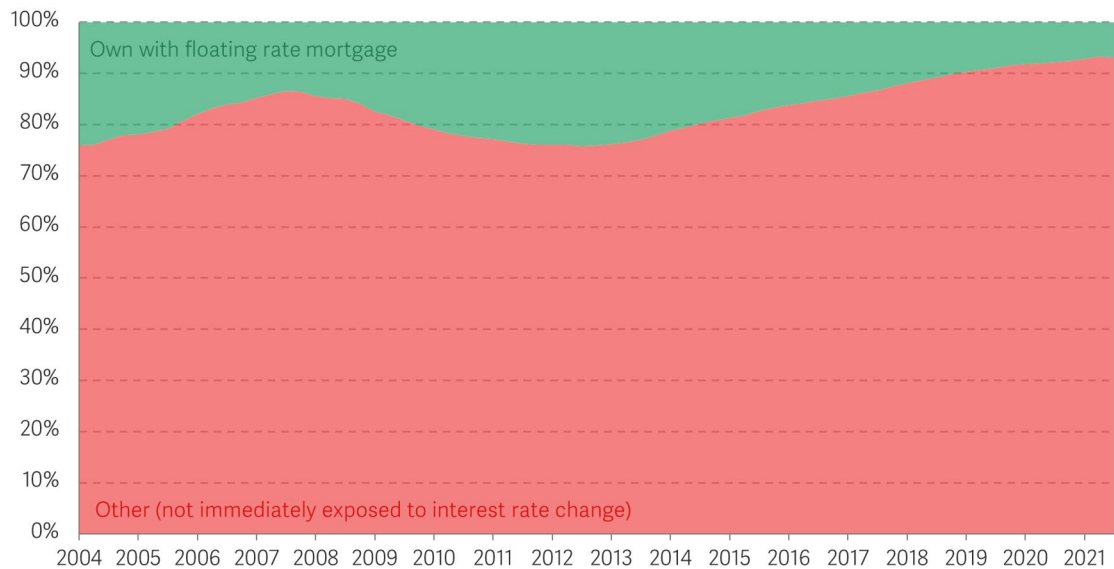
Notes: Data is collected quarterly and the first data point in the year refers to February. The series are mean-adjusted to match the average inflation rate from 2009 to 2021; this is because households consistently overestimate inflation relative to the CPI outturns.

Source: RF analysis of Bank of England, Kantar Inflation Attitudes Survey November 2021.

The direct effect of today's policy change will be small

The small rise in interest rates will not have a large direct impact on families' finances. This is because the number of families exposed to 'floating rate' mortgages – the cost of which will rise quickly following today's rate rise – has been falling both because the number of fixed rate loans has been increasing and because the number of mortgagors has been falling. As shown in Figure 4, the proportion of families with floating rate mortgages has been falling for a number of years and now just 6.9 per cent of families hold this sort of debt. In addition, during the pandemic households have – in aggregate at least – [seen wealth increase](#) as savings have risen and some forms of debt have been repaid. This will also tend to reduce the impact of higher rates.

Figure 4 **Impact on economy of changing rates has declined**
 Proportion of families exposed to floating rate mortgages



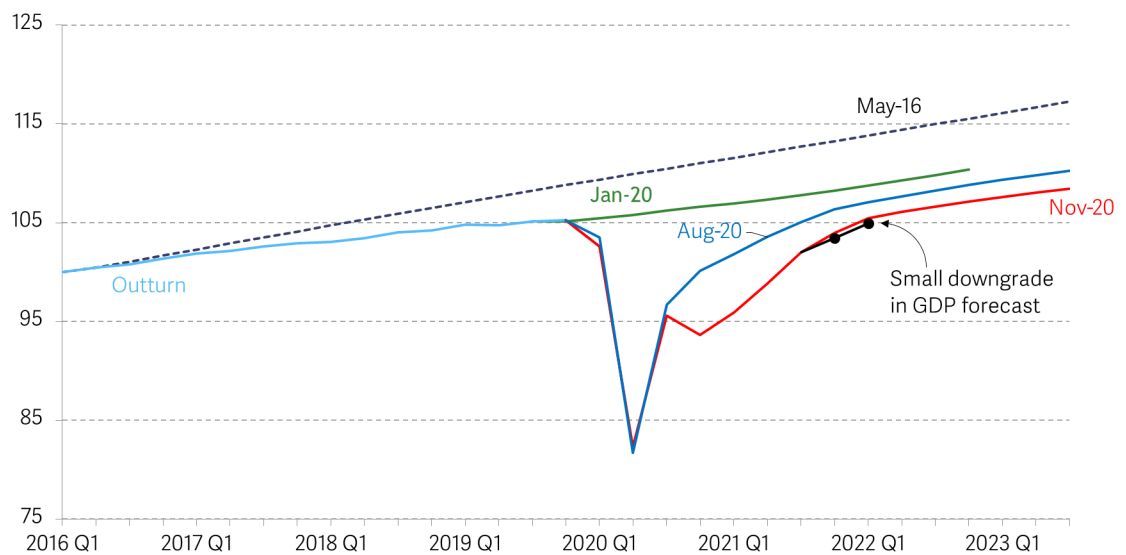
Source: RF analysis of ONS, Wealth and Assets Survey; FCA/BoE.

Moreover, despite a number of other ways in which interest rate changes feed through to the economy, rates remain at a low level and so the impact should be small. Higher rates will also tend to increase the cost of borrowing for firms. It will also increase the cost of debt repayments for the Government, tightening the fiscal position. And rate rises can also lead to a tightening in financial conditions as asset prices fall and the value of the pound increases. But given this is a small change, and rates remain incredibly low (the Bank of England's policy rate has been lower than 0.25 per cent in only 20 of the getting on for 4,000 months the Bank has been in existence!), the impact through these other channels should also be small.

Fiscal policy remains the main 'game in town' and will need to respond to the risks from Omicron

The truth is that fiscal policy has played the key role of supporting the economy through the pandemic. When the pandemic hit, the Bank quickly cut rates and restarted its QE programme. But the pre-existing low level of interest rates – and the nature of the crisis – meant that fiscal policy was much better placed to support the economy. Since then, the Government has put support measures worth around £350 billion in place. These policies have been very powerful in minimising the damage from Covid-19 on household living standards, including via the labour market. By contrast the Bank of England has played a supporting role by continuing its purchases of government debt in financial markets.

Figure 5 **The economic outlook has deteriorated**
 Real GDP, outturns and successive Bank of England forecasts: UK



Source: RF analysis of ONS & Bank of England, Monetary Policy Report, various.

It will be down to the Chancellor to support the economy as we face the new wave and a cost of living crunch. As set out in our [previous work](#), the emergence of the Omicron variant is set to lead to a huge rise in infections. Given this, it's hard to see how further restrictions can be avoided without the NHS being overwhelmed. Even if the Prime Minister continues with his trademark optimism and puts off introducing new measures for as long as possible, we are already seeing evidence of a sharp fall in social spending (dining out has fall by around 20 per cent since the news of the new variant broke) and timely measures of economic activity have fallen sharply (for example, the PMIs for December were down sharply). There was some sense of this today from the Bank as it acknowledged the weaker outlook for the economy (Figure 5). And even before the emergence of Omicron, rising energy bills and broader increases in the cost of living meant that the real (inflation-adjusted) value of pay is likely to already be falling. Given all this, the Government should act quickly to provide economic support to affected areas of the economy. Reviving a more

limited version of the furlough scheme is the best and quickest way to achieve that, supported by [other targeted measures](#). Taking steps as soon possible to ensure that we get through the coming winter as safely and painlessly is the priority. All this means the real focus should be on what the Chancellor does next, rather than on today's policy change from the Bank of England.