Resolution Foundation

Crunch time

Bank of England raises rates again and signals cost of living crisis is set to deliver a £1,200 hit to incomes

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Today the Bank of England's Monetary Policy Committee raised rates at a fourth successive meeting – a first in the 25 years since it was granted independence – to 1 per cent, a level not seen since the financial crisis. The direct impact of this change in rates on households will be small in the short term not least because less than one-in-ten mortgagors have borrowing linked to Bank of England rates. Although these effects could build over time if the Bank tightens further, there was a clear signal from the Bank that markets should calm down in terms of how high rates might go. Indeed, based on market expectations for rates to rise to 2.5 per cent over the next year, the Bank forecast is for unemployment to rise through to the middle of this decade and inflation to significantly undershoot the 2 per cent target.

This 'calm down' message came despite the Bank unveiling an updated inflation forecast that now peaks at 10.4 per cent in Q4 this year – more than double its highest inflation forecast pre-pandemic. To a large extent this reflects the impact of Russia's invasion of Ukraine that has pushed up energy prices further. The Bank now expects the Ofgem price cap to rise to £2,750 in October, which we estimate would mean 9 million English households would be in 'fuel stress'. Indeed, the expected fall in average real post-tax labour income forecast for this year is the steepest on record at 3.3 per cent, equivalent to £1,200 to households on average, and pushing the economy to the verge of recession (and explaining why the Bank doesn't think rates will need to rise as far as markets expect).

Rising interest rates will not tackle today's high inflation or ease this year's cost of living 'crunch' – instead, the Bank of England's main task is to stop higher inflation becoming entrenched. In contrast, targeted fiscal policy is needed to support to those hardest hit by high inflation. The easiest way to do this is by uprating benefits, supporting those hurt most by fast rising energy bills.

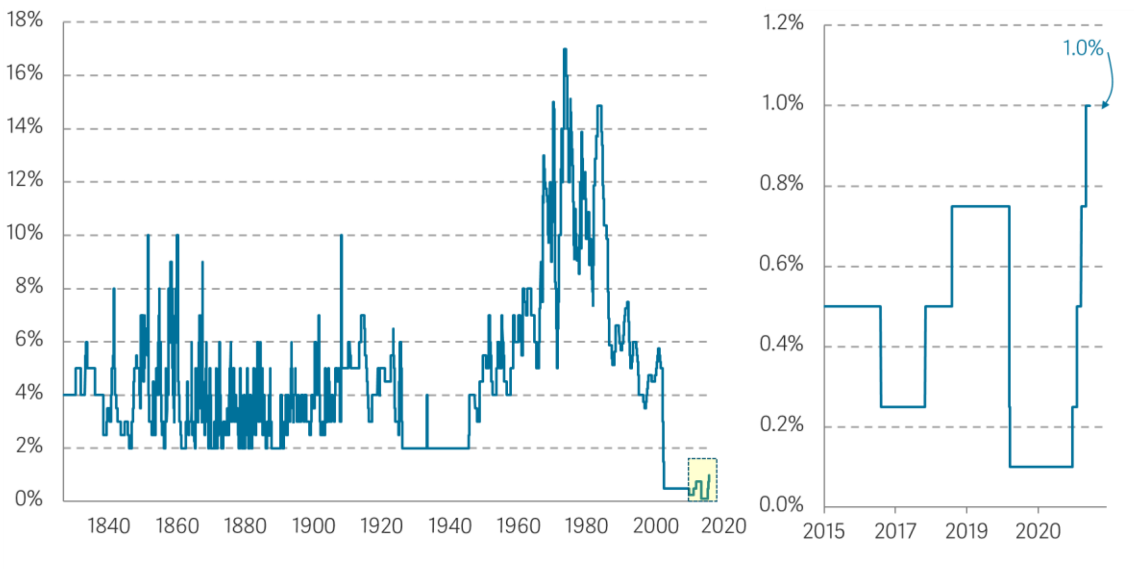
Bank of England tightens policy for the fourth meeting in a row

The Bank of England's Monetary Policy Committee (MPC) raised rates for a fourth meeting in a row today. This is the first time in the 25 years of the MPC that it has taken such a step. The

0.25 percentage point increase it announced took the Bank's policy rate (Bank Rate) to 1 per cent – its highest level in more than 13 years when rates were cut sharply during the financial crisis (Figure 1). The Bank has come under increasing pressure to act with CPI inflation already at 7 per cent in March, and three (of the nine) MPC members voted for an even larger rise in rates (0.5 percentage points). The sharp rise in inflation reflects an increase in global energy and broader goods' prices – but this is not something that the Bank can prevent. Instead the difficultly facing the MPC is how to ensure that rates rise fast enough to stop current high levels of inflation becoming entrenched in price and wage setting, while at the same time avoiding a recession and a large rise in unemployment.

Figure 1 **The Bank of England's MPC has raised rates to highest level in 13 years**

Bank of England official policy rate: UK

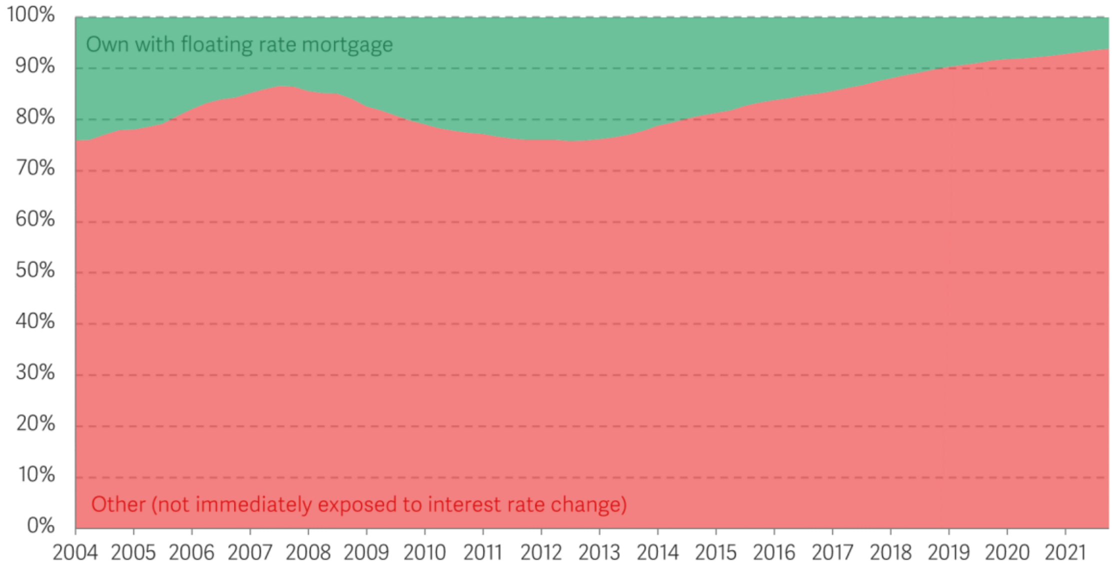


Source: Bank of England.

Today's rise in rates will not have a huge immediate impact on families, but the effects of a long tightening cycle will build

The impact of this move on households will depend on whether they are a saver or borrower, but overall should be small. For savers, there is good news here, with higher rates likely to feed through into rates paid on bank deposits. But that effect will be small as rates remain at incredibly low levels historically: Bank Rate has been lower than 1 per cent for just 13 years of the more than three centuries the Bank of England has been in existence. For borrowers with mortgages that are linked to official interest rates, there will be a near-immediate increase in their repayment. But, as shown in Figure 2, fewer than one-in-ten households are currently on variable rate mortgages, mainly because of the increasing popularity of fixed-rate mortgages. If the rate-tightening cycle does continue, however, the impact on households will build through these channels (and through the impact of tighter policy on asset prices).

Figure 2 **Fewer mortgages are linked directly to Bank Rate today than in the past**
Proportion of families exposed to floating rate mortgages



Source: RF analysis of ONS, Wealth and Assets Survey & MLAR Tables, Financial Conduct Authority.

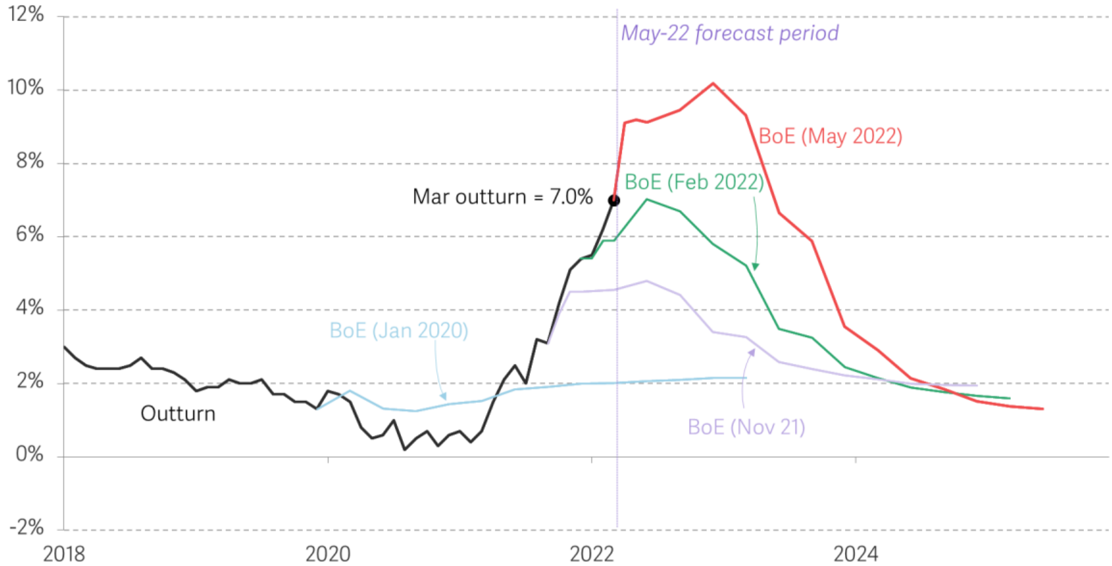
But the cost of living crisis is hurting everyone – and the Bank told us today that this will be even larger and could plunge the economy into a recession

All families will be affected significantly by high inflation that erodes their spending power – and here the Bank told us that the size of the cost of living crunch will be even larger than thought just a few months ago. This was the first inflation forecast made by the Bank since Russia's invasion of Ukraine and the conflict has led to sharp rises in global energy prices, exacerbating the post-pandemic jump in inflation. As shown in Figure 3, inflation is now forecast to hit 10.4 per cent in Q4 (October to December) this year, its highest level since the 1980s – and be more long lasting than thought just a few months ago.

The spike in inflation above 10 per cent in Q4 this year is driven to a large extent by the assumption that the Ofgem price cap rises to £2,750 for a typical household on a variable tariff in October. This is somewhat higher than current market signals suggest, but were it to materialise, more than 9.2 million English households (39 per cent) would find themselves in fuel stress (spending more than 10 per cent of income after housing costs on energy) even accounting for the Government's interventions in February.

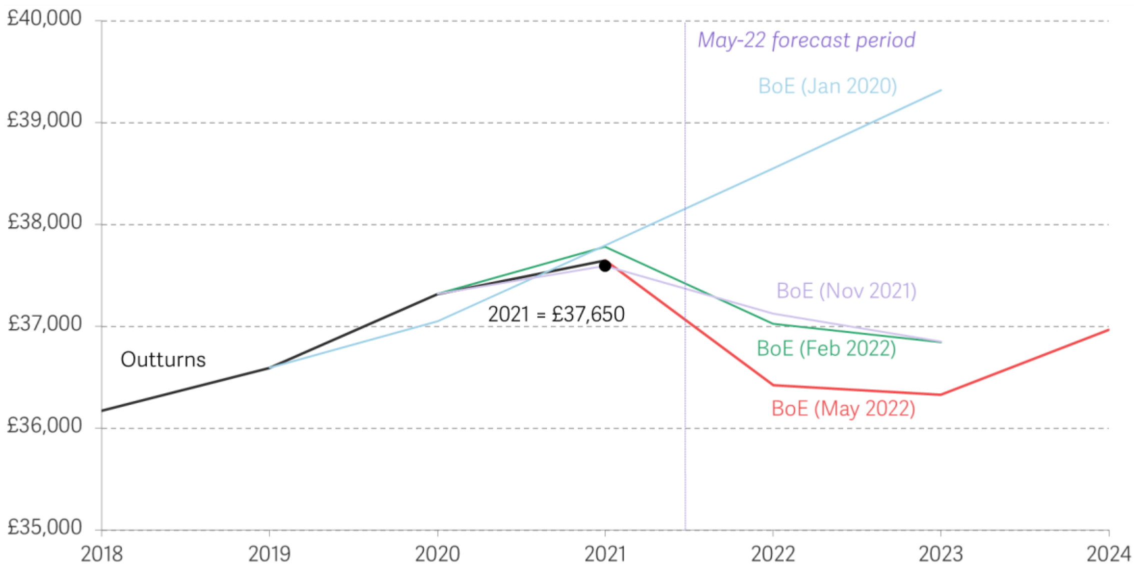
This higher inflation outlook means that the Bank is now forecasting real post-tax labour income will fall by 3.25 per cent this year, equivalent to an income fall of around £1,200 for the average household (Figure 4). This would be the weakest year on record (back to 1990) for real post-tax labour income, and the weakest on comparable measures in at least 45 years. For those on benefits, the Bank of England's new forecast for inflation means that the loss in the value of benefits is equivalent to around £15 billion in aggregate this year, driven by their being uprated at just 3.1 per cent in April this year (when inflation is expected to be 9.1 per cent).

Figure 3 **The Bank is forecasting that inflation will return to 1980s levels**
Bank of England projections for CPI inflation: UK



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

Figure 4 **Real post-tax labour incomes are set to fall by around £1,200 this year**
Bank of England projections for real household disposable income per household: UK



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

The Bank signalled that it thinks the extent of interest rate rises priced in by financial markets are excessive. Based on the market rate expectations, the economy is close to falling into recession around the turn of the year (growth in the final quarter of this year is negative and almost zero in the first quarter of 2023 – very close to the technical definition of a recession), and inflation is set to fall way below the Bank's inflation target in three years' time. All this is a clear signal that the Bank believes market expectations for future rate rises have risen too far.

The Bank of England's is not aiming to ease the cost of living crisis – that is fiscal policy's job

The extent of the cost of living crisis revealed by the Bank of England today along with the risk of recession raises the question of how policy makers can best support families worst affected – and here the answer is targeted fiscal policy rather monetary policy. The monetary policy tools at the disposal of the Bank of England are best used to ensure that high levels of inflation do not become entrenched. The nature of the rise in imported energy goods prices means that achieving this without tightening too much and derailing the economy is difficult for the MPC. But dire outlook living standards makes it clear that more Government action is needed. While the Chancellor can't shield everyone from impact of higher inflation, he has plenty of scope to provide more targeted support for the low-and-middle income households worst affected by this cost of living crisis.

The best way to do this is through the benefits system. Here bringing forward next April's benefits uprating - currently project to be around 8-10 per cent. For example, an 8 per cent uprating in benefits would be the equivalent to around £600 a year on the basic state pension and over £300 on a single adult's basic Universal Credit. While even this may not be enough to fully cover the October price cap rise for many – or indeed other increases in the cost of living – it would be a major intervention. It would also have the added bonus of no longer-term cost for the Treasury.

The Government could also look to move the costs associated with the Renewables Obligation and Feed-in-Tariff schemes from electricity bills into general taxation. Doing so would cut the average bill by £92.50 per year, but would not target support at those on lower incomes.

Depressing forecasts from the Bank of England highlight the need for action

To conclude, the Bank's forecast lays bare the scale of cost of living crisis. The years ahead are going to be much tougher for the public and policy makers than we hoped. But there is still more we can do to provide targeted Government support to families through the crisis. The sooner that support is made available the greater the chances it will prevent the economy sliding into recession. There is a strong case for stepping up sooner on fiscal policy rather than waiting until August when the next rise in the price cap is expected to be revealed.