The Bank of England’s decision to raise interest rates is justified after nearly a decade of unprecedented stimulus but the economy faces stiff headwinds.

Tighter Times

If the impact of a rate rise is so limited, why do it? The ostensible answer is that the Bank is not fulfilling its mandate to target inflation. The target of 2% is as close to a commitment as it currently is a full point above that. Moreover, growth picked up in the third quarter, to 0.4 per cent from 0.3 per cent in the previous quarter, and the labour market is strong. The unemployment rate stands at just 4.3 per cent. If these headline numbers do not justify a rise in rates to a still historically low level, then the British economy must be in a fragile state indeed. Sadly this appears to be the case. The headline numbers are a little deceptive.

The rise in inflation arises from the depreciation in sterling after the Brexit vote. GDP growth over the past 12 months amounts to just 1.5 per cent, which is the weakest expansion since 2009. Real incomes are under pressure not only because of inflation but because sluggish wage growth, and that in turn reflects Britain’s stubbornly low productive growth. Unemployment about Brexit negotiations and Britain’s future place in the international trading system is denting businesses from investing. Weak growth has depressed tax receipts, making it more difficult for government to ease fiscal policy. As a result the contrast between this rate rise and that of 2007 could scarcely be greater. A decade ago, Britain’s economy was at the tail end of a long expansion. The workload in financial markets was unprecedented. The housing bubble had been a topic since 2000. The financial crisis was not a decade ago. The price inflation has ruled many young people out of home ownership. House prices are unlikely to be affected by the rise. The Bank to cut again. Its decision yesterday to slightly tighten policy merely restores the status quo ante. 

Borrowers in variable-rate mortgages will face slightly higher monthly payments. Only borrowers with variable-rate mortgages. They will see.

The cost of borrowing remains extraordinarily low. Indeed the Bank of England cut rates dramatically to 0.5 per cent in 2009, after the failure of Lehman Brothers panicked financial markets. Rates stayed at 0.5 per cent until the unexpected vote for Brexit last year prompted the Bank to cut again. Its decision yesterday to slightly tighten policy merely restores the status quo ante.

Losers from a rise in interest rates include borrowers with variable-rate mortgages. They will face slightly higher monthly payments. House price inflation has ruled many young people out of the market, however. The allied decline in variable-rate mortgages is barely one in ten families are likely to be affected by the rise in rates.

A quarter-point change in the cost of borrowing was not a huge shift, but these are far from normal times for Britain’s economy. The Bank of England’s decision to raise interest rates, historic, being the first since increase since 2007 and from a record low of 0.25 per cent. It is the right decision, and high-street banks should follow it.

Taking an option to ameliorate some of the costs of a decade of unorthodox monetary policy.

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