

The way to cure inflation is to cut the Bank of England...

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I posted [this thread on Twitter](#) this morning:

We face a cost of living crisis created by events outside the UK triggering rates of inflation that many in this country have never witnessed before. In the face of these rising prices the Bank of England has, inexplicably, increased the price of money itself. This is bizarre. A thread.....

For reasons that are very hard to explain, the Bank of England, which is wholly owned and controlled by the UK government, is claimed to be independent of it. That is not true.

The law that supposedly established this independent status (The Bank of England Act, 1998) did not do so. It contained a clause that always permitted the government to overrule the Bank. As a result the Bank always does what the government wants.

What the Bank has, in that case, done for the government over the last eighteen months or so is massively increase the cost of money in the UK. They did this by increasing the base interest rate set by the Bank from 0.1% to 4.5%.

This rate is expected to rise further this week. A rate of 4.75% is most likely come Thursday. It is thought the rate will now reach 5%, or more.

The interest rate increases that the Bank has put in place are intended to achieve one purpose. That is to reduce the spending power of people in the UK. That is because the Bank (and government) believe that people in this country have too much money to spend.

This belief is based on theories on the cause of inflation developed in the 1970s. It was presumed then that inflation was caused by wages rising faster than prices. The excess spending power that this created then dragged prices in its wake, resulting in inflation.

Whether this actually happened in the 1970s is open to debate. What is clear is that, excepting the case of a minority of quite wealthy and high-earning people in this country, this situation does not exist today.

Evidence is very clear that, again excepting the case of a minority of quite wealthy and high-earning people in this country, real pay has for most people in this country been stagnant for a long time, whilst for public sector workers it has been in free fall.

So, again excepting the wealthy and high earners, pay in this country has not and as a matter of fact could not have driven inflation, and nor can it do so for a long time to come because most wage earners have neither the income or savings to force prices up.

So why have we got inflation? The answer is that we reopened after Covid too quickly, resulting in those with wealth seeking to spend on high-ticket items when supply chains to the UK and within it were disrupted.

That pushed prices for some goods and services up for a while. Cars were impacted heavily. So was the cost of new kitchens and building work in general. That situation is, however, now long gone.

In the place of this short-term, and entirely self-correcting inflation, there has come inflation from another source. That is the inflation that has come as a result of war in Ukraine.

But, again, and quite remarkably, most of that inflation has now gone. Wholesale food and shipping prices have now returned to pre-war levels. Gas and petrol prices have fallen drastically from their peak. The underlying causes of price war-based rises have now gone.

But inflation has not. There must be other reasons for that. There are, actually, three.

The first is Brexit. It has created continuing supply chain disruptions and has imposed considerable extra costs that are fuelling continued inflation. This fact cannot be avoided.

Second, there is profiteering. Banks, oil companies and many companies in food supply chains are very clearly increasing their absolute levels of profit, and their profit rates. This is not true for all companies, but it is for many.

The third reason for inflation is that the Bank of England has pushed up the cost of money, and is clearly intent on continuing to do so. This is seriously inflationary, in itself. That needs explanation.

The Bank of England pushes up the interest rate in an attempt to reduce the demand for goods and services. Its logic is that if borrowers pay more in interest cost they will

have less to spend. That means demand in the economy should fall, and so, it thinks, should prices.

There are some massive assumptions in that logic. The first is that most people are borrowers. In other words, sufficient people are impacted for demand to fall enough. This is not necessarily true: fewer younger people have mortgages now, for example.

Second, they assume interest costs are not themselves reflected in inflation calculations, but that's wrong. A lot of borrowing costs are now hidden in other price. Take the cost of car rental contracts as an example. 90% of cars are leased, and that cost is in inflation.

Third, rent is a massive cost for many people. In the 1970s it is unlikely that this was insignificant. But now rent is 40% of the cost of living of renters in London. And rent paid is heavily related to interest costs: landlords pass their costs on. Interest is inflationary, then.

Fourth, landlords are not alone in passing on interest costs. Many businesses are financed by debt and pay a lot in interest. The bank seems to assume markets set prices and so businesses can't pass their costs on, but large ones (most especially) can, and do.

In that case, increases in interest are inflationary, yet again.

And let's not pretend that people who have their disposable income pushed down don't try to recover that lost income. We know that they do, even if the Bank of England has been quite clear in their instruction to them not to do so.

And employers then pass on wage rises, even if (as in most cases) the increase in wage costs is less than the inflation rate reflected in business prices. So, interest rate increases reinforce inflation, yet again.

And then we shouldn't forget that some people are made better off by interest rate rises. Many savers see their income go up as a result, and most of them will not be borrowers. So they have more to spend as a result of the Bank's actions.

What is more, because savers also have money in reserve they can dig into those funds to pay increased prices if they still want to spend - and because of their increased income, plus the expectation that prices will only increase if they don't do so now - that's what they do.

I could keep going. My point is that all the assumptions that the Bank makes on the impact of interest rate rises appear to be based on what economics text books say, and the relationship between economics textbooks and reality ceased a long time ago.

It is my suggestion that the Bank of England has not only got their assumptions wrong,

they are so blinkered that they cannot see that it is their own interest rate rises that are now stopping inflation falling by creating an upward inflationary cycle.

And we do know the Bank has got their assumptions wrong. They have, for example, already had to abandon their models for forecasting inflation because, as they have admitted, they simply do not work.

Getting your model wrong is one thing. Getting your policy wrong is something else when that policy has real-world implications and they are the opposite of what you intend. That, I suggest is what is happening right now. Interest rate rises are creating inflation.

This would not matter if everyone (businesses, households and international economies) suffered inflation at the same rate. But they don't. Inflation is making most people in the UK poorer right now, and some a lot richer. And it is making us poorer compared to other countries.

The Bank of England is, then, undertaking a massive redistribution of income and wealth right now at cost to those on lower incomes. But also the country as a whole. And this matters as well.

Let me just deal with the income impacts. When those without savings and who borrow see their incomes fall the Bank of England is right: they do eventually spend less. They have no choice. They pay the essentials and hope to survive.

What they cut out are the fun things in life. The trouble is that going out, buying a beer, dressing up and so on all create lots of employment. All of that is under threat. And so even those not feeling the direct impact of borrowing costs see their incomes under threat.

This is a doom loop spiral that in economics is called a multiplier effect. In the macroeconomy if a person saves then someone else does not get as much income as they hoped for, so they too save, and on the process goes. The impact can be big. It creates recessions.

And this downward doom loop multiplier effect amongst those with lower income is not compensated for by those with larger incomes. Although they might have more income as a result of growing interest rates they save some of it. It's because they save that they are wealthy.

What that means is that the wealthy might spend more but they do not spend enough to compensate for the downward spiral those on lower incomes create.

That means that the Bank of England gets its wish: if it keeps increasing interest rates it will eventually get the recession it desires. And let's not pretend there is any surprise in this: the Bank has always wanted a recession to control inflation.

In straightforward terms then, the economic problems that we now face are, at the very least, being partly created by Bank of England policy. I think that they are mainly created by it.

Because the Bank to have never understood that interest rate rises would never address the inflation we got from 2021 but did them anyway, we now have continuing inflation precisely because the Bank has increased the price of money by raising the official interest rate.

If you want to know why inflation is now stubbornly high in the UK, that is the answer. And the response from the Bank of England will be to raise the rate still further. That will mean things cannot get better. It's as straightforward as that.

What, then, should the Bank be doing? I suggest four things. First, it should tomorrow announce no rate increase. It should say that in the face of uncertainty about whether its policy is working it will hold rates for the time being. This will change market expectations.

Second, next month it should say that rates have peaked. This will end the market expectation of rises, for good.

Third, at the same time, the Bank should end its policy of quantitative tightening which is only being done to support high interest rates. This will take £80 billion out of the economy this year which the economy cannot afford. This should start rates falling in financial markets.

Fourth, in two months time the Bank should begin to cut rates. Let them start slowly, and ideally, then speed up. But this policy is essential. Not only will it slow down inflation, which interest rate rises are fuelling, it will also keep people in their homes.

And then the policy is to wait and see. No one in macroeconomics can ever predict anything precisely. But what we do know is that what is happening now is both not working and is causing very real harm.

In that case, what is wrong with trying something that might work and most definitely will do good?

I am very confident that good will flow from this move. Nothing can now reduce the upward pressure on prices more than a cut in the Bank of England's official base interest rate. It's time it happened.