Funding the Future

Why interest rate rises are fuelling inflation

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I have been suggesting that interest rate rises are fuelling inflation.

That idea might, it seems, shock the Bank of England. They seem to think that inflation is down to excessive pay increases. However, I have some news for them, which is that employees do not set price increases. It is companies that do that. In that case, let me put forward a model of a company that is largely service-based to explore my suggestion.

This is the starting point for this model:

	Start point
	£
Costs	40
Wages	50
Interest	5
Profit	5
Sales price	100

The figures have been chosen for purely representational purposes: they are denominated in monetary units (thousands, tens of thousands, or millions: it makes no difference) but also, in effect, indicate the percentage split in the cost base of the company. The proportion of wages suggests it is service orientated, as most companies are.

Then I suggest that adjustments for inflation be taken into account, as follows:

	Start point	% increase	Actual increase	Resulting total
	£	%	£	
Costs	40	10	4	44
Wages	50	6	3	53
Interest	5	160	8	13
Profit	5	6	0.3	5.3
Sales price	100		15.3	115.3

Bought-in costs have increased by 10% - roughly the rate of inflation in the last year.

Wage increases have been kept to 6% - which will be tough on many staff.

The big increase is, however, in interest costs. The company pays interest at 3% over bank base rate. So, the rate has grown from near enough 3% to 8%, or a growth of about 160%.

In comparison, profits have only been targeted to increase at the same rate as wages.

The resulting overall cost increase is 15.3%, with more than half of that being due to interest, which imposes a bigger cost increase than external costs and the wage settlement combined.

Let's presume the company realises that the market will not accept a 15.3% price increase, and it keeps it to 10%. This is the result:

	Start point	% increase	Actual increase	Resulting total	Total to keep price rise acceptable
	£	%	£		
Costs	40	10	4	44	44
Wages	50	6	3	53	53
Interest	5	160	8	13	13
Profit	5	6	0.3	5.3	0
Sales price	100		15.3	115.3	110

Profits have now been eliminated. The company's future is, then, in doubt.

I stress that this is a model.

I would add that the assumptions seem fair, as does the cost structure, although these (of course) vary widely.

My points are threefold. First, it is not wages that are driving up inflation.

Second, it is interest rate rises that are driving up prices.

And third, interest rate rises are now so extreme that many businesses will face the threat of failure.

The Bank of England is welcome to use this model and think about the consequences which they have created. Unfortunately, I suspect that they will not. That's because what this model makes clear is that we face a crisis created in Threadneedle Street, but they have no understanding of what they have done and are doing.

And that's why we face desperate economic times.