Funding the Future

We're in an economic policy mess. It's time to admit it...

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The Bank of England cut interest rates slightly yesterday, against my expectations.

Noting this, nothing they did changes my sentiments expressed in my video and post published yesterday. There were many reasons for that.

First of all, the vote at the Bank of England was 5 to 4 to make this very modest cut. There is no confirmation as a result that this direction of travel will continue. The UK economy badly needs major cuts in Bank of England base rate. I have no confidence that they are on their way.

Secondly, that is despite the fact that, as this chart published by the Bank yesterday shows, it is their belief that inflation is now well and truly under control.

Whilst, due to a statistical aberration, the reported inflation rate will increase later this year, the Bank would appear to be confident that the trajectory of those rates is markedly downward, with the expectation being from 2025 onwards that rates should be below 2%, which is the target. This table makes that clear for the later periods.

Table 1.A: Forecast summary [(a)] [(b)]

	2024 Q3	2025 Q3	2026 Q3	2027 Q3
GDP [(c)]	1.5 (0.5)	0.8 (0.9)	1.4 (1.3)	1.7
Modal CPI inflation [(d)]	2.3 (2.2)	2.4 (2.5)	1.7 (1.8)	1.5
Mean CPI inflation [(d)]	2.3 (2.4)	2.5 (2.6)	2.0 (1.8)	1.8
Unemployment rate [(e)]	4.4 (4.3)	4.6 (4.7)	4.8 (4.9)	4.6
Excess supply/**Excess demand** [(f)]	0 (-¼)	-1 (-1)	-1¼ (-1¼)	-¾
Bank Rate [(g)]	5.1 (5.0)	4.2 (4.4)	3.8 (3.9)	3.5

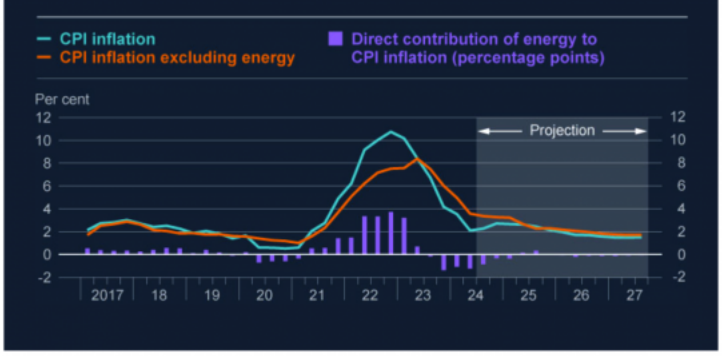
(a) Figures in parentheses show the corresponding projections in the May 2024 Monetary Policy Report.
(b) Unless otherwise stated, the numbers shown in this table are modal projections and are conditioned on the assumptions described in Section 1.1.

What that same table makes clear is that the Bank has no intention of cutting base rates significantly despite the fact that inflation will run below expectations from 2025 onwards. The plan is to restore real interest rates to a level of about 2 per cent.

The real problem with this plan is that the higher the real interest rate, the greater is the cost of investment. Investment has been low since 2008, and the real interest rate during that period has, most of the time, been negative. How and why the Bank believe that investment might increase because it is now going to impose positive real interest rates on the economy is very hard to work out. Most certainly, the bank is continuing to work against Rachel Reeves’ objective of delivering growth.

To continue to justify this policy of high interest rates, the Bank would now appear to be adopting a number of ruses. For example, it is creating a variety of inflation rates to suggest that it has reason to be concerned even though the overall level is below the target rate. So, for example, they produced this chart which differentiates inflation and inflation excluding energy costs, which it is expected will fall:

Chart 1.1: CPI inflation and CPI inflation excluding energy [(a)]



Sources: Bloomberg Finance L.P., ONS and Bank calculations.

(a) Energy prices include fuels and lubricants, electricity, gas and other fuels.

The increase in energy costs was, of course, one of the major and entirely external reasons why inflation rose in the first place. Now that it is falling it is being used as an excuse to keep interest rates high. That appears to rank as hypocrisy.

The same is true when they seek to differentiate inflation rates for physical products and services, as they are. Throughout the whole history of inflation, the single figure in an index for the change in this rate will have always reflected considerable underlying variations in the rate with regard to differing goods, products and services. That is inevitable and should be widely known. It must have been known by those who set a target based on the single index figure. But now the Bank is trying to argue that because the rate of inflation in services is above target, even though there is actually deflation in the price of goods within the UK economy, they have reason to be concerned about inflation rates in services when that figure is not their target, but the overall rate is. I believe that this action on their part is disingenuous. I believe that the resulting policy is also deeply damaging.

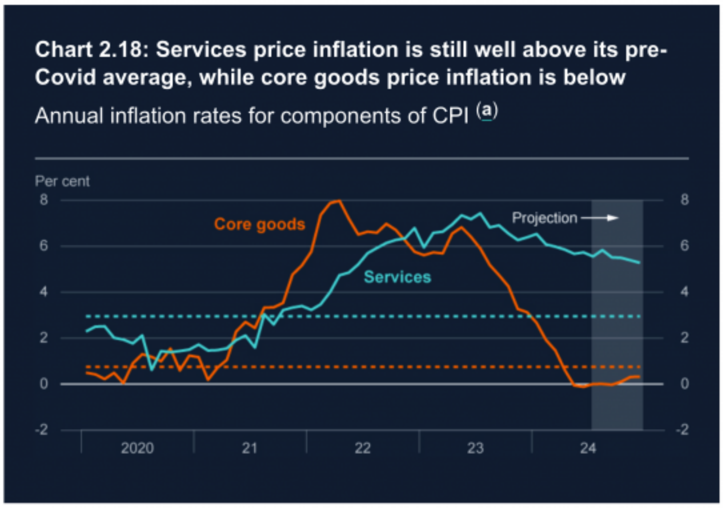


Chart 2.18: Services price inflation is still well above its pre-Covid average, while core goods price inflation is below
Annual inflation rates for components of CPI [(a)]

Sources: ONS and Bank calculations.

(a) The core goods component is defined as goods excluding food and non-alcoholic beverages, alcohol, tobacco and energy. Data to June 2024. Bank staff projections from July 2024 to December 2024. Dashed lines represent 2010-19 averages.

The net outcome of all these shenanigans is that the Bank is honest about the fact that growth is going to be weak. It will be lower than many other economic areas:

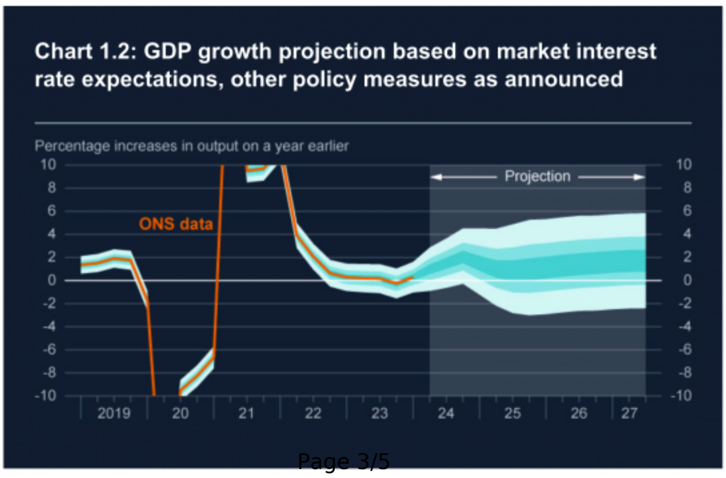
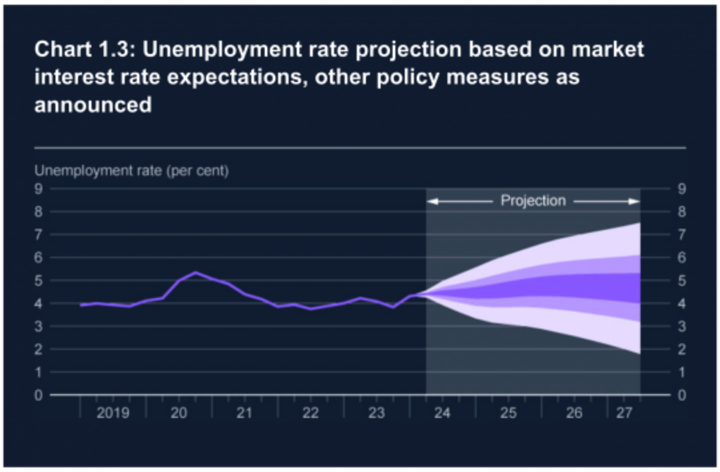
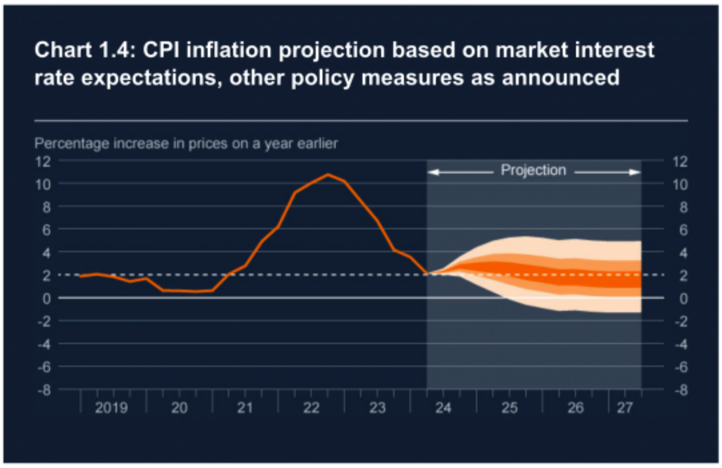


Chart 1.2: GDP growth projection based on market interest rate expectations, other policy measures as announced

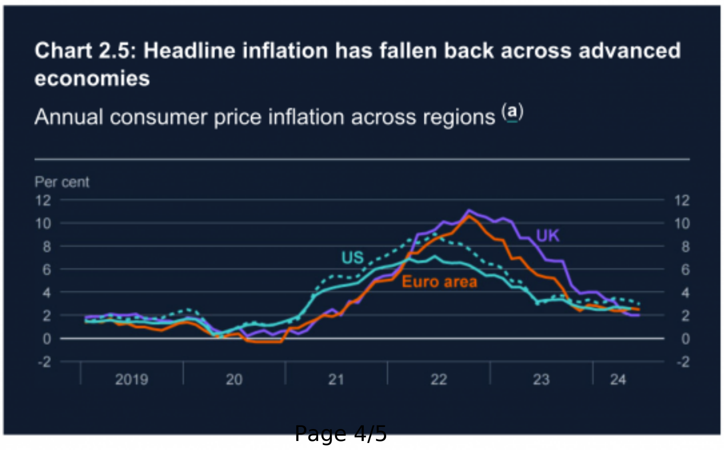
Unemployment is also going to rise, as I have long suspected is the Bank's aim:



And, this punishment will be delivered so the Bank can overshoot its totally arbitrary 2 per cent inflation goal:



And just for the record, the Bank has not delivered the fall in inflation. It happened everywhere. The cause of the inflation and its decline must be external in that case, as I always argued. Panic buying after Covid and market rigging when war in Ukraine broke out created inflation, and increased interest rates did nothing to correct those things:



Sources: Eurostat, LSEG Workspace, ONS, US Bureau of Economic Analysis, US Bureau of Labor Statistics and Bank calculations.

So, we end up with a situation where rates remain massively above any rate required to control inflation and any rate required for the well-being of the country, its economy and the people who live here.

Worse, the only thing we know is that the Bank intends to maintain strong positive interest rates that will continue to depress the net incomes of millions of households in the UK as they struggle with mortgage and rent costs. At the same time, the incentive to invest will be low. Just about nothing Labour wants will happen, and apparently, Rachel Reeves is quite content for this to happen.

Watching the news last night, it seemed as if there was a celebratory mood at the news of the puny cut in rates the Bank announced. I feel nothing of the sort. My concerns about the Bank and its destructive and unjustifiable policies remain as profound as ever.

Nothing suggests to me that it has the interests of this country at heart.

Everything suggests to me that we have a central bank and government who at least think that they have their feet on different pedals when it comes to economic policy - one on the accelerator and the other on the brake. Nothing good can ever come of that.

We're in an economic policy mess. It's time to admit it, and sort it out.