Why the central banks are raising interest rates

Synopsis: With a few exceptions, central banks around the world are pushing up interest rates in response to rising inflation. Why?

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Last week's Monetary Policy Report from the Bank of England was a gloom laden 101 pages.

Its baseline projections included…

- Inflation reaching a peak of over 13% in the final quarter of this year and still at 9.5% in 2023 Q3.
- A fall in real post-tax household income of around 2% in the year to 2022 Q4.
- A 2.25% contraction in GDP in 2023 followed by another 0.25% shrinkage over the following 12 months.
- Unemployment rising from 3.8% in May 2022 to 6.3% in three years' time.

With such a dire outlook, why did the Bank decide to raise interest rates by 0.5%, its largest increase in 27 years and the sixth consecutive rise?

The answers are many and include…

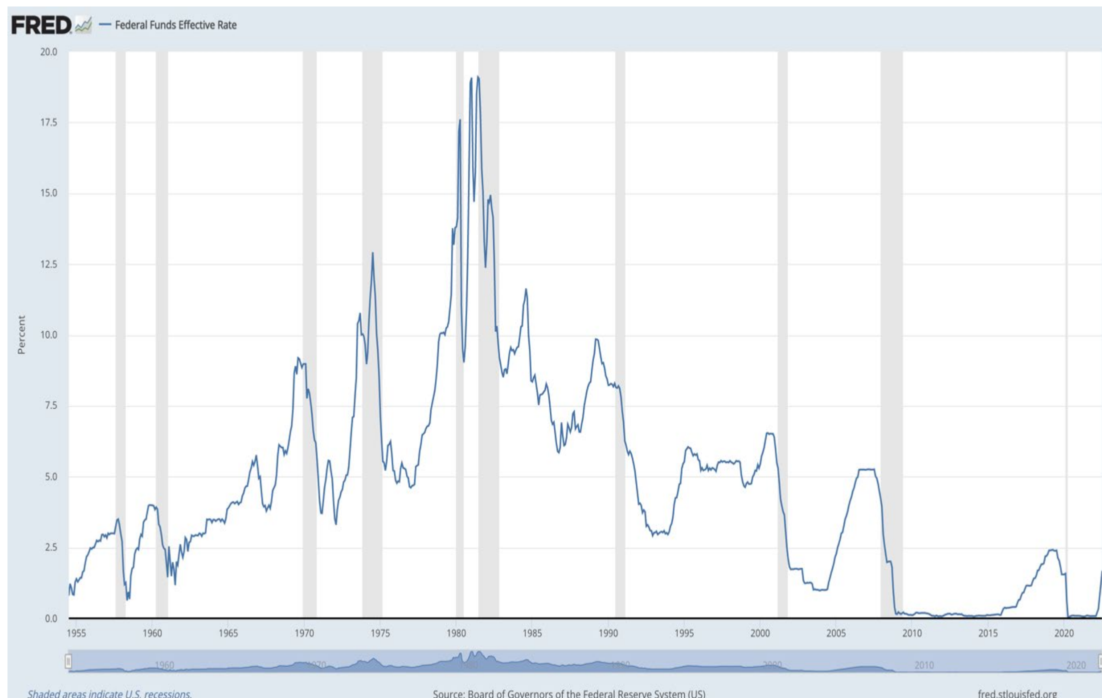
- The markets had anticipated such an increase, helped by various messaging from the Bank of England. A smaller increase or none would have surprised the markets, something central bankers avoid because they need credibility to be effective. If markets suddenly decide a central bank is faltering, there can be volatile and unwelcome consequences.
- The Federal Reserve, European Central Bank, Bank of Canada and Swiss National Bank had all raised rates by more than 25 basis points in recent weeks. The Old Lady of Threadneedle Street needed to show similar resolution. This harks back to the need for credibility.
- Raising interest rates is the one piece of the central bankers' toolkits which is seen as the main way to constrain rising prices.

Proof of the effectiveness of rate rises is often summed up in one word: Volcker. Paul Volcker became Chairman of the US Federal Reserve in 1979, at a time when inflation was running at 11.0%.

Volcker was tasked with beating inflation, which had been a problem for the USA economy for over a decade. His strategy was to push up interest rates to above 19% (the blue line on the graph below), creating two recessions (in 1980 and 1981-82 – the grey shading), during the second of which unemployment reached

nearly 11%. That medicine produced a political backlash, but Volcker had engineered himself into an impregnable position and, by the end of 1982, inflation had come down from a 1980 peak of 14.8% to under 5% and interest rates had dropped below 9%.

Effective Federal Funds rate 1955-2022



Source: St Louis Federal Reserve (aka FRED)

The Volcker approach can be summarised as...

- Raising interest rates to reduce demand in the economy.
- Keeping the interest rate pressure in place so that the reduced demand worked through to lower supply.
- Letting that fall in supply lead to increased unemployment.
- Allowing that rising unemployment to bring down wage inflation, breaking the wage/price spiral.

The current Chairmen of the Fed, Jerome Powell, is viewed by some commentators as adopting a Volcker-type policy, given that the US is already in a technical recession (two consecutive quarters of negative growth).

At the most recent rate setting press conference he said "[The Fed] *actually think*[s] *we need a period of growth below potential, in order to create some slack so that the supply side can catch up."*

Powell carefully avoided accepting that the US was already in recession, pointing out that "*there are just too many areas of the economy that are performing too well*" for that to be the case.

Friday's news that nonfarm payroll numbers rose by 528,000 gives some support to Powell's stance. The current view of the US financial markets is that, by the middle of next year, the US economy will be in a recession deep enough to prompt the Fed to start reversing the rate increases of 2022.

There has been some debate about whether the Fed was too late in beginning to raise rates – its first increase was not until 17 March 2022. That illustrates one of the difficulties in using interest rates as a counter-inflationary weapon: no central bank wants to slow the economy unless it is necessary.

Up until the turn of the year, the Fed has seen inflation as 'transitory' – a blip caused by post-COVID supply chain issues that would not have any long-term effects. On that basis, the Fed held rates at around zero and let the economy grow, even though inflation reached 6.2% by October 2021.

In the mid-2000s the Bank of England took the same look-through-the-blip approach when inflation spiked because of a fall in the value of sterling. Interest rates are not a tool to deal with inflation driven by external events over which a central bank can have no or very little control.

Which brings us to the UK in August 2022.

Last year the Bank of England, like the Fed, was a member of 'team transitory' on the inflation front. It is easy to forget now that in July 2021, UK CPI inflation was 2.0% - exactly on target. Four months later it was 5.1%, prompting the Bank to raise the base rate from 0.1% to 0.25% just before Christmas.

What drove that jump in inflation was largely transport and energy costs, not the Ukraine war, which did not begin until 24 February 2022. By the end of 2021, five out of the 12 CPI categories, accounting for about 35% of the index, had inflation rates below 4%.

That war is a perfect example of an inflation-creating external event over which the Bank has no control, so why is it increasing interest rates now?

The answer goes back to the problem Volcker faced – inflation that had become embedded in the economy via a wage/price spiral. The Bank of England says in its latest Monetary Policy Report, *'The labour market remains tight, and domestic cost and price pressures are elevated. There is a risk that a longer period of externally generated price inflation will lead to more enduring domestic price and wage pressures.'*

Break down June inflation numbers and while transport and energy are still the main drivers, only two of the 12 CPI categories have inflation at less than double the Bank's 2% target and, unfortunately, that duo (Health and Communication) represent just 4.6% of the index; inflation has spread throughout the economy.

Unlike the Fed, which must also consider maximising employment, the Bank of England has a single mandate to control inflation. It can therefore be bolder in its recognition that a recession is looming. How much the rate rises are responsible for that recession is a moot point. They will not help, but the driving forces are rising food and energy costs, which leave the consumer with less to spend elsewhere as earnings are not keeping pace.

Markets were pricing in an interest rate peak of 3% in 2023 Q2 when the Monetary Policy Report was produced, although that has now fallen to 2.8%. Either way, in inflation-adjusted terms that is still very cheap borrowing.

The Bank is under unusual political pressure at present, stemming from the comments of Liz Truss in the Conservative Party leadership battle.

Hindsight makes it easy to say rates should have been raised earlier, adding to the impression that the Bank was – and still is – behind the curve. The Bank does not want to lose the independence it was granted 25 years ago, so it will keep raising rates until it can see evidence that inflation is turning down.

However, rates are not going to come anywhere near Volcker's 1980 levels, if only because that would bankrupt UK finances. Do not forget that the Treasury pays base rate on the funds created by the Bank of England under Quantitative Easing (QE) – currently totalling over £865bn.

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