An Economic Analysis of the Monetary Policies of Bank of England

Article: Bank of England raises interest rates to highest level since 2009.

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Bank of England raises interest rates to highest level since 2009

Unanimous MPC decision to lift benchmark rate to 0.75%

London—Gavin Jackson and Delphine Strauss, August 2, 2018

The Bank of England raised interest rates to their highest level in almost a decade on Thursday, saying recent data vindicated policymakers' view that the first quarter slowdown in UK growth was temporary.

Members of the Monetary Policy Committee voted unanimously for a 25 basis point increase, taking the BoE's benchmark interest rate to 0.75 per cent — the highest level since the global financial crisis a decade ago.

A rate rise had been widely expected, with markets pricing in the quarter-point increase almost fully in the run-up to this week's meeting.

The Bank of England is the third major central bank to meet this week, and has joined the US Federal Reserve in signalling further interest rate rises are on the way. The Bank of Japan, however, declined to join in any synchronised global tightening at its meeting on Monday, and continued its massive asset purchase programme.

The pound initially rose against the dollar following the announcement, before trading down, to end the day 0.7 per cent lower, at $1.304 — a lower level than before the rate rise was announced.

Mr Carney said the central bank's interest rate cut two years ago, following the Brexit vote, had worked but now was the time to focus on taming inflation rather than supporting jobs growth.

"The strategy has worked," he said. "Employment is at a record high, there is very limited spare capacity, real wages are picking up and external price pressures are declining."

In the minutes from this week's meeting, MPC members argued that with low productivity and lower net migration holding back potential growth in the UK, even modest increases in demand would lead to domestic inflationary pressures.

The policymakers predicted that a tight labour market would continue to push up wage growth, with further rate rises needed to bring inflation back to its 2 per cent target.

Some economists and business groups criticised the BoE for pushing ahead with rate rises while the UK economy is still hampered by uncertainty over the outcome of the Brexit negotiations, and economic data has pointed to only lacklustre output growth.

Suren Thiru, head of economics at the British Chambers of Commerce, said: "The decision to raise interest rates, while expected, looks ill-judged against a backdrop of a sluggish economy."

But Mr Carney, after being asked whether it was worth waiting for the outcome of Brexit negotiations, said it would be a mistake to hold off for "perfect certainty" before raising rates.

"There's a wide range of Brexit outcomes, but in many of them interest rates will be at least as high as they are today," he said. "So we don't need to keep our powder dry for that."

Two years after the announcement of Brexit, Bank of England has announced a raise in interest rates "to their highest level in almost a decade." In this commentary, the expansionary and contractionary monetary policies of Bank of England (BoE) from both 2016 and 2018, respectively, will be analyzed.

1. Expansionary Monetary Policy following Brexit Referendum

Following the vote for the United Kingdom to leave the European Union, the Bank of England, expecting an economic stagnation due to lower consumer and business confidence, employed an expansionary *monetary policy*—a type of demand-side government policy to change the Aggregate Demand (AD) of the economy—, with the "central bank's interest rate cut [during the Brexit referendum]." A diagram of the money market and new-classical *AD-AS* curves can be used to model this situation.

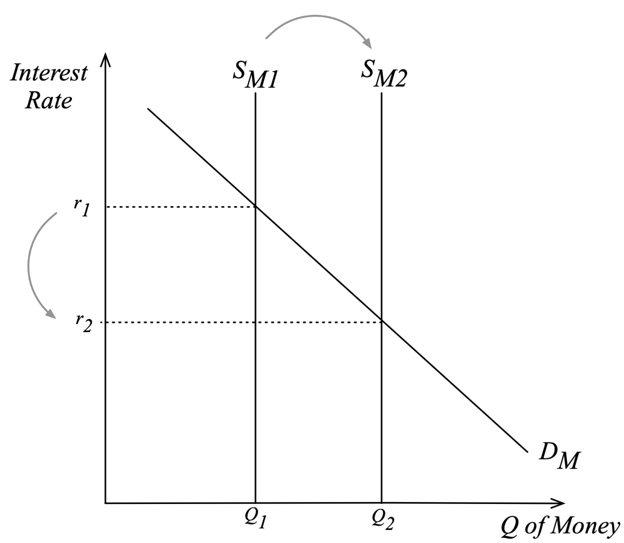

Diagram 1-A: Money Market of the British Economy

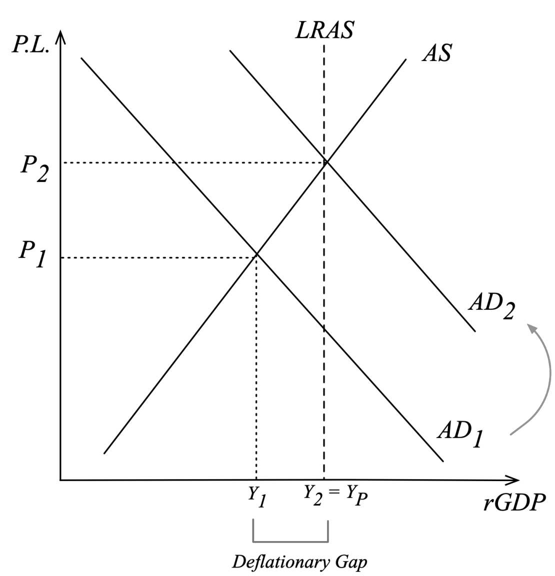

Diagram 1-B: The British Macroeconomy

As seen in *Diagram 1-A*, the central bank, BoE, can freely change the perfectly inelastic supply of money in the finance market, and adjust the *interest rate*—the price of borrowing money. The supply of money was increased from S_{M1} to S_{M2}, reducing the interest rate from r_1 to r_2. As the interest rate decreases, firms will be motivated to increase investment (I) and households will increase consumption of goods and services (C), as well as personal investments.

As $AD = C + I + G + (X - M)$, it can be predicted that *AD* in the British macroeconomy will increase. The economy, as seen in *Diagram 1-B*, is currently experiencing a deflationary gap, with the equilibrium of AD_1 and AS not meeting at the potential of the economy at the Long Run Aggregate Supply Curve (*LRAS*). According to assumptions of this new-classical model, the increase in investment and consumption will shift the *AD* curve to AD_2, with the economy at its potential, Y_P. In the long run, the economy can expect an increase in the *LRAS* itself, due to capital investments.

As the deflationary gap between equilibrium *rGDP* and Y_P decreases, the model predicts a reduction in unused resources—a decrease in unemployment, a reduction in the spare capacity in the economy. In hindsight, this indeed was the result, with the Governor of BoE suggesting that "The strategy has worked," and "employment is at a record high [and] there is very limited spare capacity."

However, the model has failed to consider the confidence level of consumers and businesses due to the high inflation that would result from the monetary policy, and the *multiplier effect* that would further the situation. Additionally, its impact on international trade, such as trade competitiveness and the exchange rate, must have been considered.

2. Contractionary Monetary Policy approaching Brexit

As the United Kingdom nears its scheduled departure from the EU, the BoE has chosen to, this time, employ a contractionary monetary policy, with the MPC suggesting that "[it is] the time to focus on taming inflation rather than supporting jobs growth." This policy can be analyzed using a Keynesian *AD-AS* Diagram.

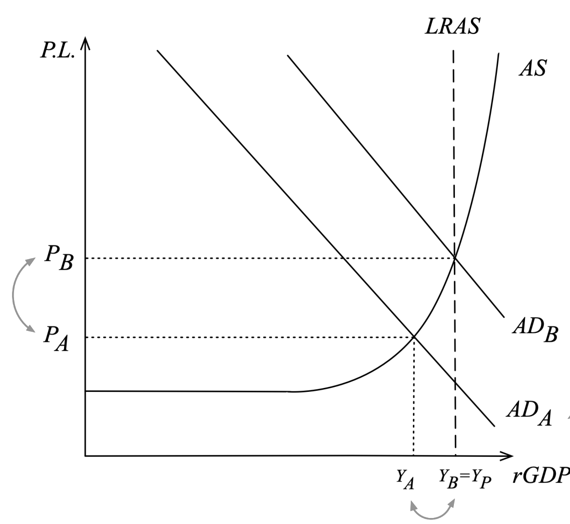

Diagram 2-A: Anticipated Outcome with change in Aggregate Demand

The article provides that the "MPC members argued that with low productivity and lower net migration holding back potential growth in the UK, even modest increases in demand would lead to domestic inflationary pressure." This prediction can be considered correct, from *Diagram 2-A*: in the current British economy with low potential, Y_P , the Keynesian *AS* curve will curve highly at even low values of *rGDP*, and therefore a small increase in *AD* from AD_A to AD_B, will increase the price level dramatically, from P_A to P_B. On the other hand, the employed contractionary monetary policy will alternatively decrease *AD* from AD_B to AD_A, and decrease price levels, keeping a low rate of inflation, as anticipated by the BoE.

Some, however, argue that this policy is ill-provided, as "economics data has pointed to only lackluster output growth," anticipating that *AD* is still far from the potential, and the reduction in *AD* by the policy will reduce output, from Y_B to Y_A. This valid criticism is especially concerning as Brexit nears and economics uncertainty compounds. It must also be considered that there will inevitably be deviations in the real life outcome from an idealized model. Monetary policies, although bypassing political processes, still has time delays in its effect. Additionally, the contractionary policy's effect may be limited due to the *ratchet effect*, as, for example, workers refuse to accept lower wages.

In this commentary, both the expansionary and contractionary monetary policies, employed at different timeframes and contexts, by the BoE, have been analyzed. Facing a time of both political and economic hardships, the Bank of England must act cautiously, to promote and sustain the macroeconomic goals of the British economy.