Will the Bank of England be raising interest rates soon?

21st September 2021

Until recently, the Monetary Policy Committee (MPC) which has responsibility for setting interest rates was undecided whether the conditions were right for tightening monetary policy. Andrew Bailey, the Bank of England (BoE) governor, revealed last month that the MPC could not categorically say that there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2 per cent inflation target sustainably.

But after last week's data on both inflation and labour it might now be the time that the Bank starts to gently tighten monetary policy. The annual inflation rate jumped more in August than at any time since the BoE was granted independence. Analysts expect the rate to rise from the 3.2 per cent last month to peak at over 4 per cent in the winter and remain more than one percentage point above the Bank's 2 per cent target until at least autumn 2022. Vacancies are also at their highest level ever recorded, indicating strong demand for labour. Payrolls are now at pre-pandemic levels indicating that significant progress has been made in eliminating spare capacity. We have also seen the number of adults who are not working but say they want a job fall to its lowest level since equivalent records began almost 30 years ago. The BoE is far more likely to damage its credibility by overshooting rather than undershooting its inflation target.

The questions for the MPC will be what to do and how quickly. They will not want to tighten policy too early, as it could undermine the coronavirus recovery and damage living standards. But if it tightens too late, there could well be too much inflation, forcing the Bank to have to be much more aggressive with subsequent interest rate rises.

Until recently, most economists agreed the first risk was more serious. It made sense for the BoE to do nothing while Bailey mitigated the risk of overshooting inflation with public comments stating the central bank was very carefully monitoring inflation. Rather fortunately the BoE has one tool at hand to tweak its monetary policy stance, and that is to end the latest round of quantitative easing (QE) when it meets later this week. This would thereby cap its QE at a around £870bn rather than continuing to the end-of-year target of £895bn. Such a move should offer little risk of undermining the recovery, and it would show markets and investors that they were being vigilant about rising inflation.

Last week's data suggests that the UK's economic facts have changed and that the MPC now needs to show that the BoE is serious about inflation. It may mean they can put off putting up interest rates for a while and still give themselves the option to loosen monetary policy once again if the recovery proves disappointing.

We have positioned the portfolios to deal with any such eventuality with holdings in both index-linked and floating rate securities which have their prices linked to interest rates and a greater exposure to overseas bonds which themselves are not impacted by the rate of inflation and interest rates in the UK. And the equities in the portfolio have historically performed well in periods of low single digit inflation as companies have been able to pass much of rising input prices onto their customers.

The timing of any interest rate rise is unclear but it feels like that time is getting closer as we enter the Autumn.

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