The likely harm of the prolonged high interest rates scenario

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Well, here we go again- another MPC meeting, the 5th in succession which kept interest rates unchanged. Rates stuck at 5.25 % until the next meeting on May 9.

But what does it all mean? A tight monetary policy continues. Not only are we now in a situation where interest rates have moved from being negative, in other words below inflation, to positive, in other words above the rate of inflation, but Quantitative Easing is also continuing with the Bank of England(BoE) still intent on selling some £100b of govt bonds from its balance sheet a year. So here we have it. Latest suggest a further tightening in lending conditions, particularly for smaller firms, the sharpest rise since 2009 in personal debt arrears likely this quarter, and a steep hike in insolvencies. It would be an understatement to say that such high rates are a worry if they stay at those levels for much longer.

Worth also remembering that the UK was officially in recession in the second half of last year. The recovery since has been modest. With manufacturing still in the doldrums, the recent improvement in activity overall is concentrated in the services sector. Can this be maintained? Retail data out now suggests that retail spending, after a rise in January offsetting a December 2023 fall, stagnated in February. More worryingly, retail sales volumes were down by 0.4% in the latest three months compared to the previous period and 1% lower to a year earlier. Yes the wet weather didn't help but sales remain 1.3% below pre-pandemic levels in real terms.

Yes consumer confidence is slowly improving again as inflation drops and real wages start to rise. But at the same time, we have seen people more cautious and reluctant to spend already as the February retail sales figures show. Borrowing costs and for many who do not own their homes, rents are now rising above inflation limiting real disposable income for many despite the cut, now reinforced in the budget of March 6, in the National Insurance Contributions rate. And surveys of businesses suggest that plans to raise prices ahead by most firms are moderating to reflect that reality.

The problem is that the extra monetary tightening we are seeing as real interest rates rise sharply is accompanied by continued fiscal tightness too. Yes, there have been some personal tax giveaways in the last few months but conditions for business have hardly eased. Business rates are going up for many businesses by over 5% in April, though the smaller firms business rate relief has been extended by another year. The corporation tax rate remains unchanged and the near 10% rise in the minimum wage in April will mean even more pubs and restaurants but also many more SMEs are likely to go to the wall.

All eyes therefore on the BoE to provide some relief ahead. What are the chances of that? No doubt they are better than they were. Inflation expectations among the population which the BoE monitors were falling even before we saw the slightly better than expected drop in the year- on- year Consumer Price index to 3.4% in February. And the Bank itself is anticipating there will be periods very soon when inflation could fall to below its 2% target. Keeping rates so high given those underlying trends is unsustainable. Even the 2 uber- hawks on the MPC have given up calling for a rise in rates with the vote on March 21 being 8 for pause and one voting again for a cut.

Indeed following the MPC meeting, the UK bond markets clearly decided that the trend from here on is downward and mortgage rates were quickly trimmed back. In the US the previous day after a pause there again but with a clear indication of 3 cuts planned for the rest of 2024, stock markets soared.

So a cut will come. But remember that interest rate rises take a good 18 months to two years, according to the BoE's own analysis ,to have a full effect. So arguably more pain to come as some of the increases we have seen have yet to impact the economy. The question therefore is whether those cuts will be soon enough and substantial enough to salvage the UK from just modest recovery -or will a further pre-election fiscal boost in the autumn, as the Chancellor Jeremy Hunt has recently been hinting, be required.

Well, if nothing else, it is all promising to be an interesting few months ahead!

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