Factors affecting interest rate decisions

Instructions:

Divide students into pairs, get them to read the analysis and then come up with a list of factors which influence interest rate decisions. Then ask them which factors they believe to be most important and finally get them to make a recommendation. This article is updated regularly (see link), so if there are significant changes in the economy, it might be worth going to the site and downloading the most recent analysis.

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The indicators to watch that will determine when interest rates go up

Whilst the BOE is now claiming that not just one economic indicator will be used in any 'forward guidance' of when rates will rise, a range of them will still determine when they actually do put them up. So economic indicators are still important in judging when interest and mortgage rates are likely to rise. Below is a roundup of the most important indicators to keep an eye on which will influence when interest rates go up:

So what might influence when rates rise, despite the change in the BOEs 'forward guidance'?

Inflation remains low after turning negative

In February the official measure of UK inflation fell to 0%, but then fell to -0.1% (the lowest level since 1960) in April. Inflation is now once again back at 0%. That means that the cost of living is the same as this time last year. Inflation has tumbled in recent months, the biggest reason being the fall in the price of oil as well as heavy discounting in the shops. Inflation doesn't look like spiking any time soon either and Mark Carney has admitted as much in his latest inflation report. In fact, Mark Carney correctly predicted that inflation would fall to below 0%. Don't forget that the Bank of England's target inflation rate is 2% (with anything above 3% or below 1% getting a slapped wrist from the Chancellor). To combat inflation interest rates would be increased but the prospect of low inflation for the foreseeable future has fuelled speculation that the first interest rate rise will now not occur until well into 2016.

Official support for a rate is gaining traction

Between August and December 2014 the Bank of England's Monetary Policy Committee (MPC), who are the people who decide the UK base rate, were not unanimous in their support for holding interest rates at 0.5%. In fact, 2 out of the 9 committee members consistently voted for an interest rate rise. However between January 2015 and July 2015 MPC minutes showed the voting once again became unanimous (9-0) for holding rates. This resulted in the market predicting that the first rate rise would not occur until late 2016. But in August 2015 one MPC committee member broke rank again and began calling for a rate rise. This was somewhat expected as Mark Carney had been dropping hints over the last few months. But what was surprising was that only 1 member voted for a rate rise as markets had expected more members to vote for a rise. But as mentioned above, this is not the first time that the MPC voting hasn't been unanimous and they could still change course.

The UK economy has rebounded

UK economic growth had been faltering but the latest figures from the Office of National Statistics confirmed that the UK economy grew by 0.7% in the second quarter of 2015. That means that UK economic growth is back at its pre-crisis level. Yet a growing economy still increases the prospect of a rate rise. In recent months Mark Carney had publicly stated that the low oil price could in fact see economic growth rates soar and force an early rate rise, which was met with much derision. It would seem he might have been right after all.

There's cautious optimism about future economic growth

Be it the UK services, manufacturing or construction, official data has pointed to improved signs of economic recovery. Yet the services sector which accounts for about 75% of the economy has been driving all of the recent upturn in economic growth, with the construction sector being flat over the second quarter and the manufacturing sector contracting. This lopsided growth could undermine future growth prospects. However, if the economic recovery strengthens then interest rates will rise sooner and faster than suggested by the official guidance.

Unemployment has stopped falling

The number of people out of work fell by 15,000 to 1.85 million in the three months to May. This was a bit of a shock as unemployment had been falling steadily over the last 2 years. The UK unemployment rate still sits at 5.6%, well below the BOE's old 'forward guidance' threshold, a threshold the BOE hadn't expected to be breached until 2016. But interestingly wage growth now comfortably exceeds inflation - a trend we last saw back in 2009. In fact the growth in annual average earnings jumped to 3.2% which is comfortably above the current rate of inflation and the fastest rate for 5 years. A lack of wage growth is a sign of slack in the economy which would make an early rate rise less likely. But if wage growth continues to improve then calls for an interest rate rise will increase. The only stumbling block will be if the rate of unemployment keeps falling.

UK economic growth forecasts are being tempered

While there is optimism for UK economic growth the previous bullish forecasts have been repeatedly downgraded. The Bank of England now expects the UK economy to grow by 2.4% in 2015, which is slightly lower than the 2.5% forecast in March and well below the 2.9% forecast back in February. The Confederation of British Industry has also downgraded its forecasts, predicting economic growth of 2.4% for the UK in 2015. Interest rates are unlikely to be raised until economic growth is more stable.

Source:

http://moneytothemasses.com/owning-a-home/interest-rate-forecasts/latest-interest-rate-predictions-when-will-rates-rise#

(August 2015)

Using the article, identify the main factors that influence the Bank of England's inflation decisions – bullet point the key factors contained within the analysis.

Which 3 do you think are most important?

Based on the information, do you think that the Bank of England should increase interest rates next month?