

### Evaluate the factors considered by the Bank of England when setting the interest rate.

The Bank of England, the UK's central bank, is responsible for managing monetary policy and the supply of money in the economy. It is operationally independent from the government, which sets the inflation target to be met. The target is 2% as measured by the Consumer Price Index (CPI) and is symmetrical with a tolerance of +/-1% permitted on the central 2% rate. If the inflation rate exceeds 3% or drops below 1% then the Governor of the Bank of England is required to write a letter to the Chancellor of the Exchequer explaining why the inflation target has been missed and the policy actions being taken to remedy it. The Bank of England is also responsible for directing other aspects of the government's monetary policy framework, such as quantitative easing and forward guidance as well as generally supporting the government's economic policy. The Monetary Policy Committee (MPC) of the Bank of England meets eight times a year, to decide the official interest rate in the United Kingdom (the Bank of England Base Rate). At each of their meetings, the members of the MPC consider a large amount of information on the state of the economy.

In the past under what were 'normal' economic conditions the interest rate would be around 5% but after the financial crisis of 2007-09 the 'new normal' interest rate was thought to be nearer to 2.5%. Speaking in 2015, the Governor of the Bank of England, Mark Carney, suggested that interest rates would reach that 'new normal' rate in early 2017 but in the spring of that year they were down at the historically low 0.25% having been cut from 0.5% in August 2016. [A factor that the Bank of England must always consider when setting interest rates is the state of the economy several months ahead.](#) This is because it is estimated interest rate changes take up to eighteen months to have their full effect on the economy. This means monetary policy needs to try and predict the state of the economy for up to 18 months ahead of any possible interest rate change. As can be seen in the above example, forecasting uses data which is often very unreliable – rather like trying to steer a car down a hill with all the windows blacked out except the back one!

The Bank of England Governor recently explained that when interest rates do rise from their historic lows that the rates will go up only gradually. Mark Carney also said that high household debt levels and a fundamentally altered financial system meant it was virtually impossible to raise interest rates much above 2.5% in the medium term. [This introduces another factor that must be taken into account when the MPC is considering a change in interest rates, interest rate elasticity.](#) This measures the extent to which changes in the interest rate affect the components of aggregate demand and consequently the inflation rate. Ideally the MPC needs to be aware of responsiveness of consumption, investment and the exchange rate to an interest rate change otherwise policy action will be ineffective. Interest rate elasticity can be estimated but it varies from region to region in the UK and exogenous shocks can change it either temporarily or permanently, making policy decisions on interest rates difficult.

[A third factor that the MPC must consider is the rate of growth of GDP and the size of the output gap.](#) A positive output gap arises when aggregate demand (actual GDP) is growing faster than potential GDP causing inflationary pressures. This will indicate that a rise in interest rates is needed to reduce aggregate demand. A cut in rates would be required for a negative output gap in order to boost aggregate demand and reduce deflationary pressures. The MPC will thus try to ensure that aggregate demand grows in line with the potential GDP of the economy. However, GDP figures are not always accurate and subject to revisions long after their publication and been already used by the MPC as a policy guide. There is also the problem of the 'hidden economy' which is unrecorded output and income as result of firms and workers

evading tax leading to underestimation of GDP. There is also a lot of difficulty in accurately estimating how much spare capacity there is in the economy.

When setting interest rates the MPC will also try to consider changes in asset prices, consumer and business confidence, the growth in wages, the unemployment figures and recent developments in the euro zone, emerging market economies and economic data from the United States, China and Japan. The key point is that the MPC has to consider many indicators from both the demand and the supply-side of the economy when setting interest rates. All of these factors provide valuable guidance but all have their limitations, hence the reason why so many factors are considered. However, unexpected events such as the financial crisis in 2008-09 make things much more difficult. A big economic lesson of the turbulent years since the financial crisis of 2008 is that central banks must not get 'behind the curve', meaning 'behind or out of touch with modern trends'. The then-Governor of the Bank of England Mervyn King was criticised for being too slow to cut interest rates in the financial crisis of 2008-09. An earlier extensive cut in rates might have softened the impact of the recession which followed.

In short it is easy to be wise in hindsight and very few saw the 2007-09 financial crisis coming. Indeed during a briefing by academics at the London School of Economics in 2008 on the turmoil affecting on the international markets the Queen asked: "Why did nobody notice it?" The Bank of England must consider a range of factors, but ultimately predicting inflation and the state of the economy remains very much a crystal-ball activity.