

A Debate of Interest: When should rates rise?

[Chris Scott](#) looks into the debate that has arisen about when interest rates should be increased

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As the financial crisis gripped the world economy in early 2009, central banks across the world lowered interest rates to levels close to zero in order to stimulate the economy. Being no exception to this, the Bank of England has maintained interest rates at 0.5% for 67 consecutive months. However as the economic recovery takes hold, there is growing pressure on the Monetary Policy Committee (MPC) to begin increasing them.

Proponents of an increase suggest that as the economy recovers there is less spare capacity, meaning that there is less scope for the economy to continue growing without triggering inflation. Recent revisions to GDP show that Britain surpassed its pre-crisis peak in the second quarter (Q2) 2013, with GDP growth of 0.9% in Q2 2014. Recent data from the Office of National Statistics (ONS) also show that unemployment is now down to 6.2%. With growth projected to continue going into 2015, optimists argue that the UK economy would be able to cope with higher interest rates, and would mark a further step on the road back to normality.

Increasing the interest rate has also been suggested as a means of deflating the housing market. Citing evidence that house prices across Britain increased by 10% over the past year, the IMF has recently warned that interest rates may need to rise in order to prevent further increases in house prices. With average household debt still at 140% of gross disposable income, there are fears that rising house prices could encourage risky lending by banks, leading to potential instability in the financial system.

However even as the economic recovery has begun to take hold, inflation has remained stubbornly low. The Consumer Price Index (CPI) estimates that it was only 1.2% in September 2014, down from 1.5% the month before. This is partly a result of low productivity, which remains 4% below its pre-crisis peak. Since low productivity also impinges on wage rises, the recovery has so far failed to translate into higher disposable income for households. As such concerns have been raised that increasing interest rates could increase costs for households, further reducing disposable income and therefore undermining the UK's GDP growth.

The effects of an interest rate rise would be particularly strongly felt by homeowners. A recent survey by the Money Advice Service suggests that 56% of mortgage holders have no contingency plans for a rise in interest rates, while 47% claim they would struggle to cover an extra £150 a month in interest payments. This comes as evidence suggests that the housing market might already be starting to cool, in response to expectations that the Bank of England is likely to impose a leverage ratio on lenders, reducing the amount of risky loans they are able to make.

Although there are growing indications that interest rates are likely to rise from early 2015, managing the

process so that it doesn't undermine the wider economy will be challenging for the Bank of England. As such any increases need to be introduced gradually, in order to help households and firms adjust to the new economic climate. If this process is managed successfully, it will be another indication that Britain is emerging from the shadow of the 2008 financial crisis.



One comment

Dave Black

24 Oct '15 at 4:00 am

So much depends on how all the 'Funny Money' (QE) is unwound. No one is going anywhere until reality prevails. Reality is the precursor and too much Fractional Reserve Banking is the ailment. You have to push up prices to cover the ante-post bet. So what happens when the debtor cannot cover his bet! They're soon screaming 'Write-off ' as in the case of Grexit. But to write-off debt destroys credit and it's back to Square One. Half the world can't exist without Social Transfers, that's why the EU is doomed. No one took account this simple fact of life. So in the end they are screaming give me more time and a perpetual debt cycle ensues Then if you try to cut the cloth according all you can hear are screams of anguish and no one is going anywhere.

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