Macroeconomics commentary

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Britain faces a protracted recession and the worst squeeze in living standards in more than 60 years after the Bank of England raised interest rates sharply and forecast inflation would hit 13 per cent by the end of the year. The Bank's nine-member Monetary Policy Committee voted 8-1 to raise interest rates by 0.5 percentage points to 1.75 percent on Thursday, the biggest increase in 27 years.The BoE's move followed similarly aggressive steps by the European Central Bank and US Federal Reserve in the face of soaring inflation. But its grim forecasts suggested Britain was facing a much bleaker economic outlook than either the US or eurozone. Households are more exposed to the energy price shock than in the US, and less protected by government measures than in the eurozone, while the UK economyhas also been damaged by the effects of leaving the EU. The Bank forecast the country would slide into a 15-month recession later this year, with GDP shrinking by more than 2 percent from peak to trough. Consensus Economics, which averages leading economists' forecasts, projects the US will grow by 1.5 percent and the eurozone by 1.7 per cent in 2023.The BoEsaid that because of the latest surge in gas prices, driven by Russia's restriction of supplies, it now expected inflation to rise above 13 per cent at the end of the year— muchhigher than its May forecast. It would remain at "very elevated levels" throughout 2023 before falling back to the 2 per cent target in two years' time."Thereis an economic cost to the war. But it will not deflect us from setting monetary policy to bring inflation back to the 2 per cent target," BoE governor Andrew Bailey said after the decision.The BoE forecasts showed that households' post-tax income would fall in real terms in both 2022 and 2023, even after factoring in the fiscal support the government announced in May. The peak-to-trough decline of more than 5 per cent in household income would be the worst on record, with data stretching back to the 1960s. The BoE also now expects a longer and deeper recession than it forecast in May. It said the economy would shrink from the fourth quarter of 2022 for five successive quarters, with an overall hit to GDP similar to that seen in the early 1990s. Even once a recovery began, the BoE said growth would be "very weak by historical standards". Sterling weakened against the euro after the decision, reflecting speculation that a lengthy recession would limit the scale of future rate rises. Its forecasts showed that inflation would hover near double digits for at least the next year but could fall below the 2 per cent target by the end of 2024 even if the central bank took no further policy action. The bleak forecasts led to angry political recriminations. Rachel Reeves, the shadow chancellor, said they were "further proof that the Conservatives have lost control of the economy" while candidates for the Tory leadership were "touring the country announcing unworkable policies that will do nothing to help people get through this crisis". The BoE is under growing pressure from foreign secretary Liz Truss, who said on Wednesday she would look to change its mandate if she becomes prime minister. But Rishi Sunak, former chancellor and her rival for the Tory leadership, said the projected surge in inflation reinforced his claim that Truss would be reckless to increase borrowing and cut taxes now. Recommended News in-depthUK interest rates Bank of England serves up a shock with its intensely gloomy outlook "The bank has acted today and it is imperative that any future government grips inflation, not exacerbates it," he said. "Increasing borrowing will put upward pressure on interest rates, which will mean increased payments on people's mortgages."Sunak's team saidthe 0.5 percentage point rise in interest rates would cost the Treasury more than £6bn in higher debt servicing costs. Truss has claimed that Sunak is partly responsiblefor pushing Britain towards recession because of the series of tax rises he introduced as chancellor.

Commentary

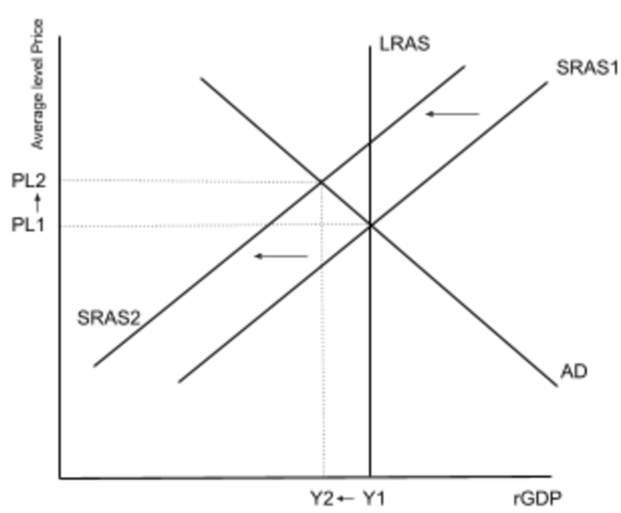
Bank of England raises rates sharply and warns of 13% inflation by end of year

The UK is forecasted to head into a recession as the economy's GDP is expected to experience more than two quarters of consecutive negative growth. The article is about the UKs central bank's decision to raise interest rates in order to counter high levels of inflation. Inflation refers to a general increase in the price of goods and services in the economy. To increase the interest rates in the economy contractionary monetary policy will be used which is when the central bank manipulates the supply of money in the economy to increase interest rates. Therefore the key concept of**intervention**will be covered as the Bankof England takes action to tame the inflationary pressures in the economy.

Much of the inflationary pressures come as a result of supply side shocks such as "the latest surge in gas prices". The UK economy faces stagflation which refers to the situation where an economy experiences negative economic growth while the general price level increases.

Higher energy prices raise production costs in the economy making it costly and difficult for producers to keep producing the same output. This is because energy has a relatively inelastic PED, meaning it's difficult to reduce consumption of the good even if the price increases. From a monetarist point of view this only affects aggregate supply in the short run, because high energy prices will in the long run lower.

Diagram A



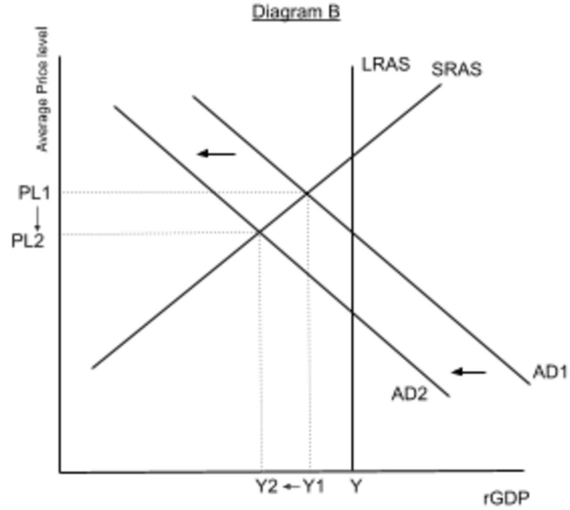
Effects of higher energy prices on the UK economy

In diagram A, higher gas prices in the economy increase production costs and as a result producers cannot produce the same amount as before, which is shown by the shift from

SRAS1→SRAS2. This creates a new price level from P1→P2 as higher production costs are passed onto consumers in the form of higher prices. Higher production costs means producers produce less goods which leads to a reduction in real Gross Domestic Product since rGDP is the value of all goods and services produced within the economy within a specific time period accounting for inflation. Thus lower output decreases rGDP from Y1→Y2.

The BoE is committed to achieving their 2% inflation goal which means that taming inflation is their top priority, even though it comes at the cost of negative economic growth and higher unemployment. This will be done through**intervention**in the economy by manipulating the supply of money in order to increase interest rates, which is raising the cost of borrowing money in the economy. The monetary tool used is increasing the minimum lending rate by 0.5% to 1.75%, which is the rate the BoE lends money to commercial banks by.

Diagram B



Effects of increasing the base interest rate by 50 points on the UK economy

As seen in diagram B, higher interest rates increase the cost of borrowing money for consumers and businesses which leads to less consumption and investment as consumers will have less money to spend while businesses reduce their investments as loans become more expensive. Since consumption and investment are components of Aggregate demand(C+I+G+(X-M)), it shifts AD1→AD2. Lower demand in the economy reduces the average price level following the law of supply and demand. As a result rGDP decreases due to the slowed economic activity and producers producing less due to the lack of demand. This further increases unemployment as firms earn less revenue which means they lay off workers to lower production costs.

When evaluating the strategies it's important to consider the macroeconomic policy objective which in this case is price stability. Therefore**intervening**in the economy with the use of contractionary monetary policy is an option as it will lower AD in the short run, while being flexible, easily reversible, and having generally short time lags. However, the solution could lead to a recession as the economy will experience slowed or even negative economic growth as a result of the higher interest rates which leads to higher unemployment and reduced output in the economy. It's also important to note that lowering demand won't have much effect on lowering cost-pull inflation because it's a supply-side issue, meaning the prices are increasing as a result of lower supply not increased demand. Therefore contractionary monetary policy won't be very effective in lowering prices in the long run. A solution that leads to an decrease in the price level while increasing rGDP, would be supply side policies, as they aim to increase the LRAS of the economy. Market based supply side policies are more favorable as they have less time lags compared to interventionist policies and make the labor market more efficient therefore help lower unemployment. However, market based supply side policies have limitations as they take time to take effect and need more time to plan which means they are not good at tackling inflation in the short run. Thus the use of contractionary monetary policy seems like the most suitable solution.

Work cited

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