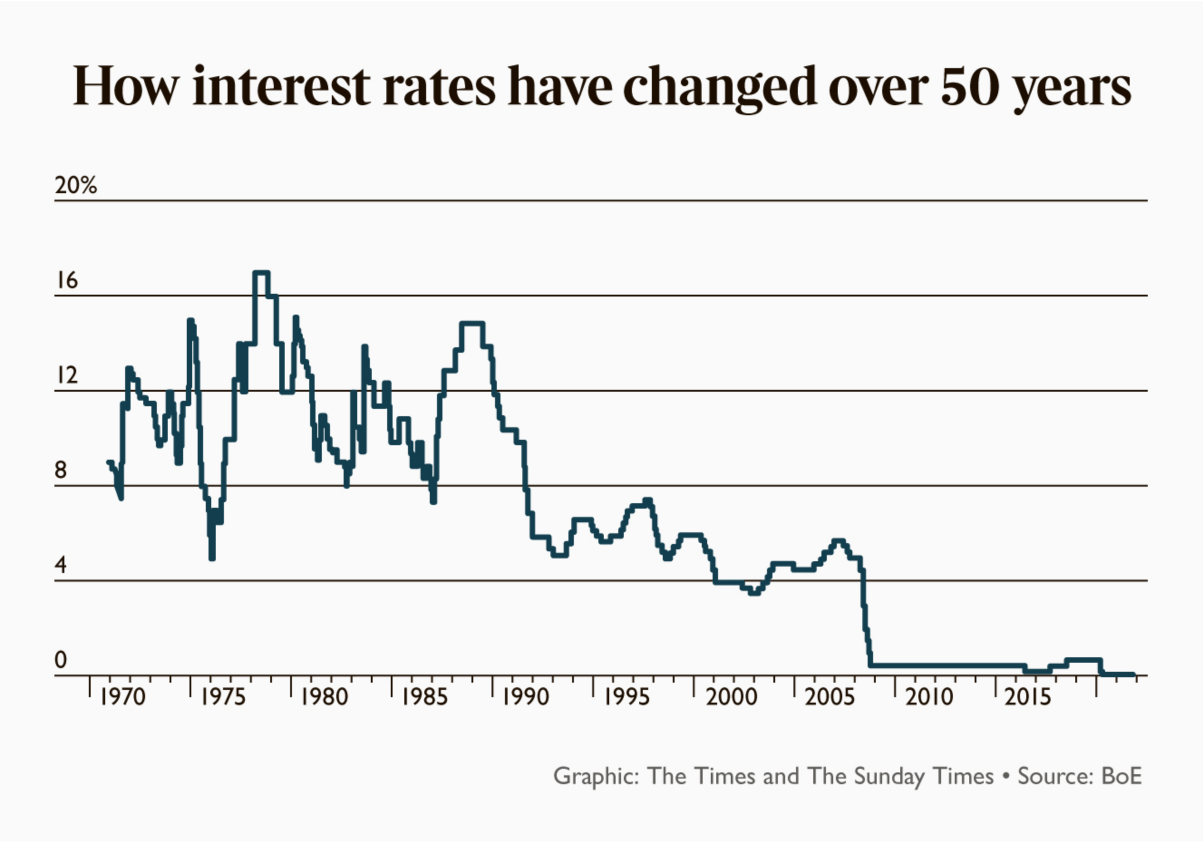
Britain gambles on higher interest rates and tax rises as economy wobbles

After this week's budget, Britain could stand alone in raising both interest rates and taxes, writes Jill Treanor

hen Rishi Sunak holds the red box aloft for the traditional photo opportunity in Downing Street on Wednesday, his smile will not last long. The chancellor will be on his way to present a budget that will signal a move away from the emergency spending spree he embarked on to save the economy from the ravages of the Covid-19 crisis.

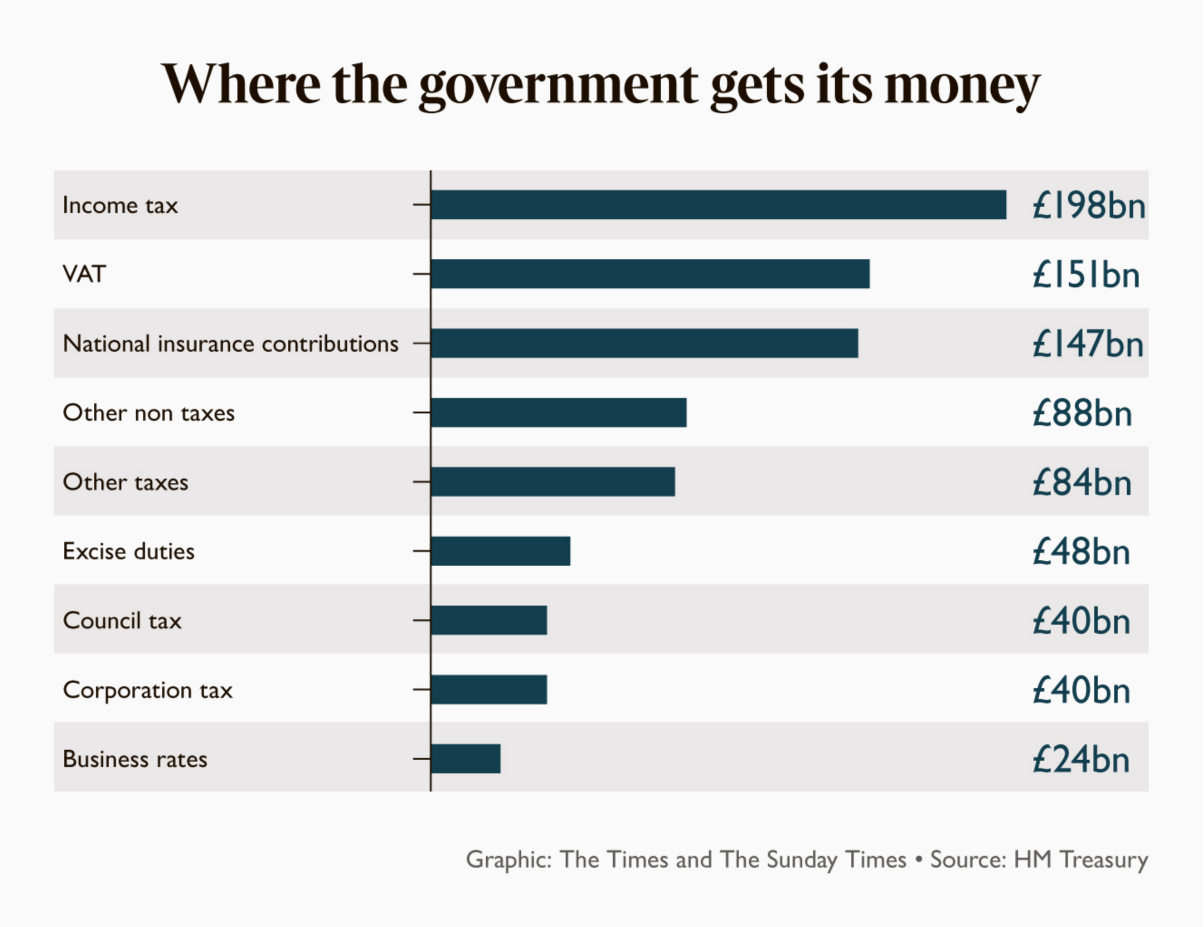
As his words reverberate around the Commons chamber, they will have repercussions at the Bank of England. In the sombre, stone-walled building in the heart of London's financial district, governor Andrew Bailey will have just a week to digest the implications for the economy before deciding whether to start raising interest rates from the record low they were cut to at the start of the pandemic.
For both men — two decades apart in age — the coming months could prove more challenging even than March last year when they were both new to their roles and the country was forced into its first national lockdown. Both were lauded for their early actions: Sunak for pouring £400 billion into support schemes such as furlough, which has averted an unemployment crisis; Bailey for presiding over a cut in rates to 0.1 per cent and pumping billions of pounds of liquidity into the financial markets to preventing them seizing up as the crisis hit. That quantitative easing has now hit £895 billion. Those who have experience of setting policy say that was the easy bit.



Andrew Sentance, who was a member of the Bank's ratesetting monetary policy committee during the global financial crisis more than a decade earlier, said: "When I was on the MPC, or looking at economic policy more generally, in a crisis it's obvious what to do, particularly when the economy needs a lot of help."

The exit strategy is much harder — and one that is compounded by an array of uncertainties. Former Conservative Treasury minister Lord (Jim) O'Neill, said: "I have never known in 40 years of thinking about the economy a time in which there were so many big issues where the outcome could go in different ways."

"That makes it fascinating [for the general observer]," the former Goldman Sachs veteran added. But, he said, for Bailey and Sunak it creates an extraordinary set of circumstances given the need to tackle inflation, climate change and spending on health and social care.



The chancellor

For Sunak, the risk is that he pulls back on spending too quickly. The MP for the safe Conservative seat of Richmond, North Yorkshire, has enjoyed a meteoric political rise. Now 41, he was elected for the first time in 2015 after a successful career in finance.

Educated at Winchester College, where he was head boy, and then Oxford, Sunak started his working life as a Goldman Sachs banker. After just three years he left for California's Stanford University — where he met his wife, Akshata, daughter of NR Narayana Murthy, the billionaire founder of IT giant Infosys — before returning to London to join the hedge fund empire run by Sir Christopher Hohn. Sunak joined rival hedge fund Theleme Partners in 2009, and had stints working in America before embarking on his political career.

As he prepares his budget, Sunak is looking at an economy facing one of its fastest periods of post-war growth as it bounces back from the collapse in March and April last year. He is focused on rebuilding the country's finances after the end of his Covid aid schemes.

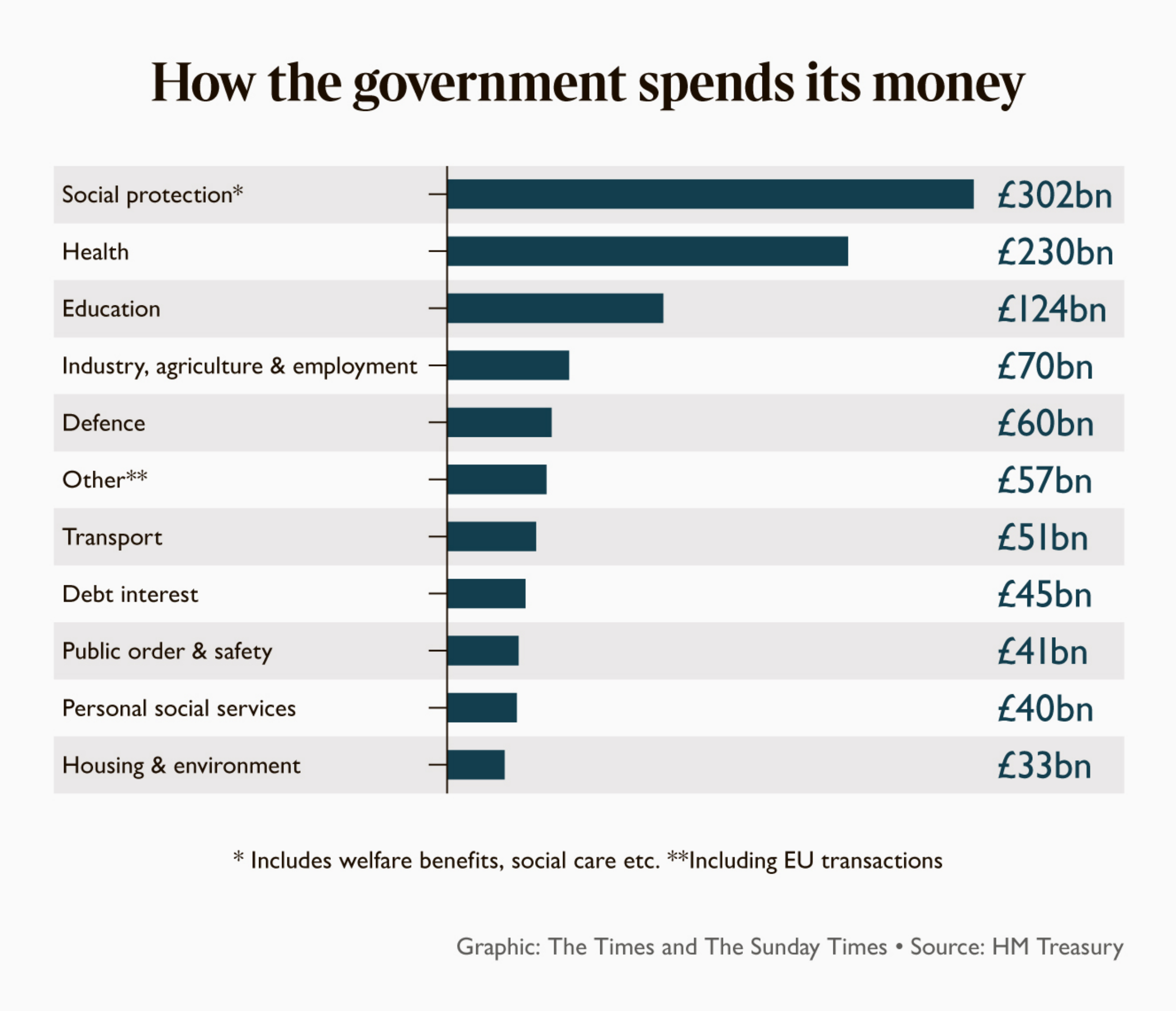
The economy has been expanding rapidly — although that growth is now slowing. That has helped cushion the hit from eyewatering growth in public borrowing. Figures last week showed borrowing in the first six months of this year nearly halved compared to the same period in Covid-stricken 2020. That unexpected bounty gives Sunak scope to relax a touch on slashing spending.

Andrew Goodwin, chief UK economist at Oxford Economics, said: "The logical thing would be to use any leeway to cushion the blow, to make the transition back to 'normal' [spending] much slower. But he seems to be on the path to get back there as soon as possible."

That "blow" Goodwin talks of was being felt even before the budget: businesses have been hit by a 1.25 percentage point rise in national insurance contributions to pay for social care. The poorest have suffered from the end of the £20 boost to universal credit.

Sunak wants to give the impression of fiscal responsibility, saying last week that he would use this week's budget and spending review to support public services, business and jobs, while "keeping our public finances fit for the future". In an interview with The Times Sunak said it would not be "right or responsible" to sustain the spending and borrowing required during Covid.

Hawks on spending point out that Sunak will still have splashed out large sums over this parliament. But some economists contrast his approach with US President Joe Biden, who is aiming to pump trillions into the American economy through spending on infrastructure and social benefits such as Medicare and child tax credits.



The governor

Whatever Sunak does in his budget could have implications for Bailey, who acknowledged early this month that the “hard yards” were still to come. Sentance, known for his hawkish stance during his five-year tenure on the MPC until 2011, said the timing of the budget left the ratesetting committee with just a week to assess whether the chancellor’s action would take demand out of the economy.

Bailey, 62, has talked the markets into thinking a rate rise is coming, possibly as soon as next week or, at the latest, at the MPC meeting just before Christmas.

As James Smith, economist at ING, put it: “We’re the only developed market economy which is considering both tightening monetary policy quite rapidly and also scaling back fiscal support quite rapidly as well.”

The 121st governor of the Bank of England is a public servant to his core and spent his entire career at Threadneedle Street until being parachuted in to the Financial Conduct Authority for a four-year stint before rejoining the Bank in March 2020.

Educated at Wyggeston boys’ school in his home town of Leicester, Bailey has a first-class history degree from Cambridge and a PhD in economic history. After a year at the London School of Economics, he joined the Bank in 1985, becoming private secretary to the late Sir Eddie George, and had his signature on banknotes as a result of his role as “chief cashier” between 2004 and 2011. This gave him a first-hand view of the bailouts of Lloyds, HBOS and RBS.

Most criticism has been heaped on him for a number of customer scandals during his tenure at the FCA, most prominently the collapse of the savings company London Capital & Finance.

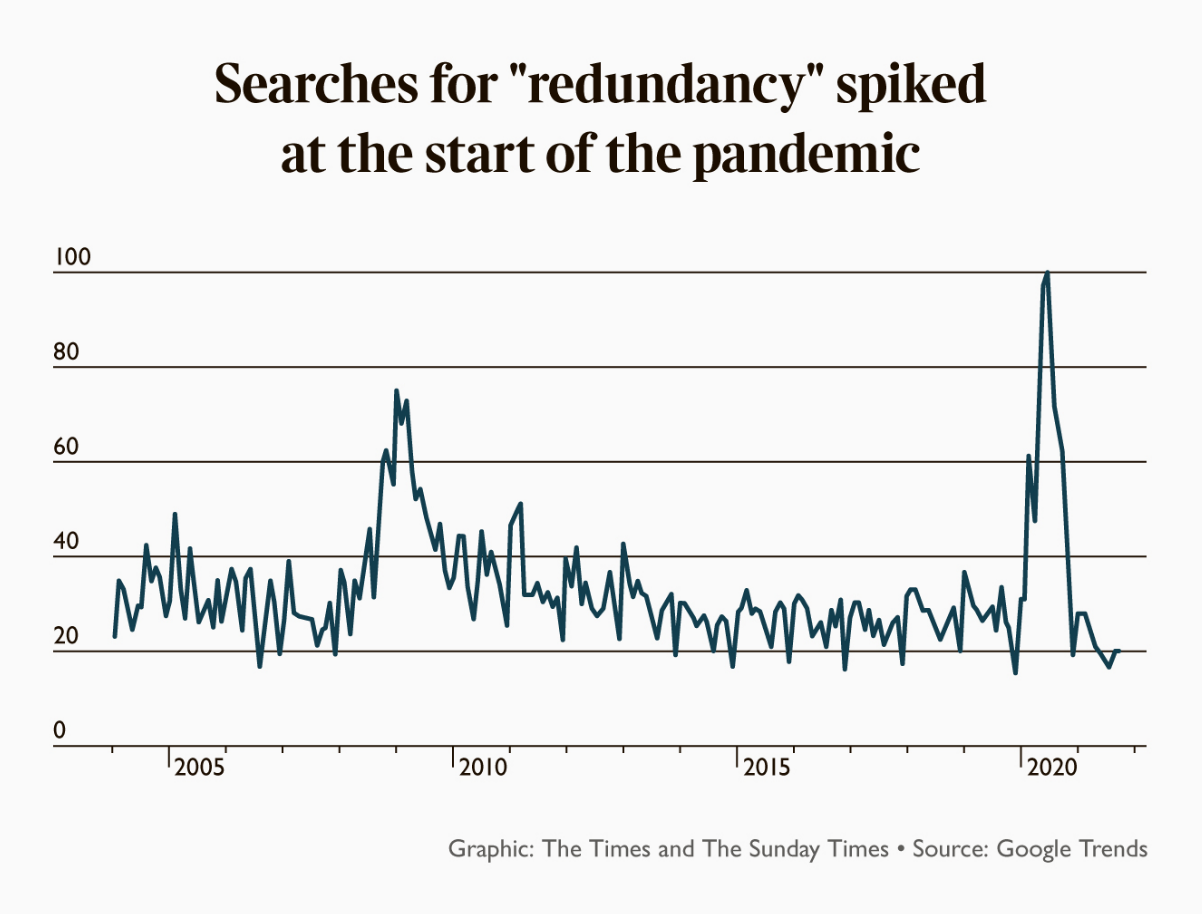
In the job of governor, he now runs the risk of earning the “unreliable boyfriend” sobriquet that Labour MP Pat McFadden handed to the Bank of England under Mark Carney, Bailey’s predecessor. The Bank of England repeatedly warmed up the market to rate rises in 2014 that failed to materialise. McFadden, now Labour’s City minister, said: “If there’s a lesson in all of that, it’s probably that predicting the future is more difficult than you think.”

That is something Bailey and the members of the MPC will be all too aware of. Data last week showed that inflation dipped to 3.1 per cent in September from 3.2 per cent in August but that has not deterred the markets from pricing in a rise in interest rates to about 1 per cent by the end of next year.

The Bank is also sitting on £895 billion of bonds — almost entirely government bonds, known as gilts — through its quantitative easing programme. That will also need to be reversed in any monetary tightening.

Even so, Mike Bell, global market strategist at JP Morgan Asset Management, said a rate rise would not have the same impact as in the past. Three quarters of mortgage borrowers are on fixed rates, for instance, which would not move whatever happens to the Bank rate. The risk, Bell said, was the impact of a rate rise would be felt only in a few years' time when those mortgage deals ended.

Bailey faces another conundrum. Periods of economic crisis are usually followed by unemployment, which peaked at 8.5 per cent in 2011 after the financial crisis and took six years to get down to 4 per cent before Covid struck. Unemployment is now at 4.6 per cent. "How does the Bank deal with the fact that economic growth looks like it's going to be strong and the unemployment rate is so much lower than in the past?" said Bell. The upshot could easily be that workers demand higher wages — in turn fuelling inflation.



Symbiotic partners

Bailey and Sunak are inextricably linked — even though monetary and fiscal policy are supposed to be separate, since the Labour government gave the Bank independence over interest rates in 1997.

Dame Kate Barker, another former MPC member, said that if there was tightening to be done to take some of the heat out of the economy, she “would rather see it done on at the Bank end, by pushing rates up, then I would see it by big cuts in fiscal policy”. Goodwin added: “If you take the fiscal support out too fast, then that’s really going to be quite challenging for growth.” That, in turn, could have an impact on the Bank’s projections about the economy and help it keep monetary policy looser. “But they both seem to be acting in concert, tightening at the same time,” he said.

O’Neill argued for a move away from the doctrine of the past 30 years that high debts and too much spending store up economic problems.

“You need a proper imaginative rethink,” he said, calling for a clearer split between spending for investment and spending for everyday purposes.

Sentance, now senior adviser to Cambridge Econometrics, wants more radical thinking at the Bank. He said the exit route from the financial crisis was too focused on fiscal policy — the austerity years of George Osborne — and that this mistake should be avoided again. “Are we in danger of repeating the same mistakes again, with too much emphasis on the fiscal side and not enough attempts to try to get monetary policy back in some sort of sensible shape?” he said.

Whether the chancellor or the governor has the more difficult task remains a hot topic for debate.