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Higher UK rates? Not so fast.

Uncertainty is rising. That has important implications for policymakers at the Bank of England.

Costas Milas is a professor of finance at the University of Liverpool. In this post, he explains why a series of sharp rate hikes in the UK will do more harm than good.

For the first time in almost 15 years, there's a chance the Bank of England's main policy rate ends 2022 higher than their inflation goal.

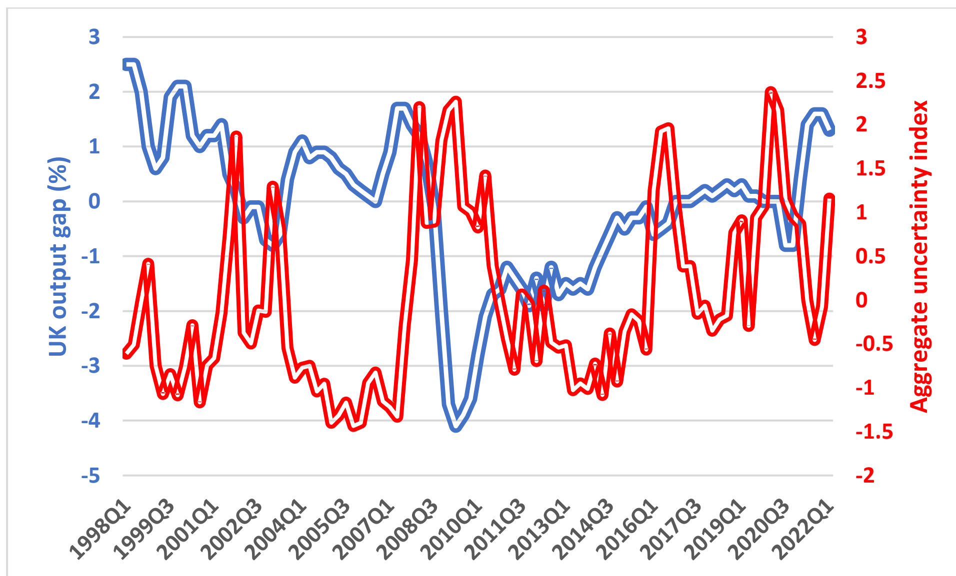
Markets expect the Bank's Monetary Policy Committee to raise the rate to almost 2 per cent by the end of this year. If that happens, it would mean rates soaring by a whopping 125 basis points over the next nine months. But will benchmark borrowing costs rise by as much as policymakers and financial markets think? Monetary bureaucrats are certainly talking tough. But tough talk is not necessarily going to be followed by strong action. Residents of Threadneedle Street, aghast at the latest inflation readings but fearful that tighter monetary policy may weigh on growth, could well be praying that jawboning alone is enough.

Expectations of higher interest rates can indeed lower inflation in and of themselves, by pushing the domestic exchange rate up and reducing the cost of imports. But the effect is likely to be modest. The sterling effective exchange rate (which considers movements in the pound against Britain's main trading partners) has appreciated by 0.93 per cent since the Bank of England started tightening policy in December 2021. About 20 per cent to 30 per cent of exchange rate movements eventually (over three to five years, that is) pass through to the UK Consumer Price Index. So, in theory at least, we should see CPI fall by between 0.19 per cent and 0.28 per cent. That's hardly enough to temper a cost of living crisis that governor Andrew Bailey described as "historic".

Talk is cheap. The impact is small. You get what you pay for. Yet the question remains: would substantial and speedy increases in interest rates, potentially more costly in terms of their impact on growth and financial stability, be worth the price? In short: no.

]To explain why we need to look at the so-called output gap – a measure of excess demand – and potential supply in the economy. When output is above potential and there is excess demand, inflation should rise. When output moves below potential, there is downward pressure on prices as supply swamps the system. Central banks use the output gap to form a judgement on whether their actions can push inflation back to their 2 per cent targets. And, after the tremendous fiscal and monetary stimulus unleashed in the UK to counter the impact of the pandemic, it would be fair to assume that demand is now in "excess". At the same time, however, the output gap is very sensitive to headwinds. Among them, uncertainty. Uncertainty harms economic growth because business delay their investment decisions and consumers become less likely to spend. That weighs on both supply and demand, but the impact on demand is more immediate – and so of more concern to policymakers now mulling a series of rate hikes.

The chart below maps the impact of this uncertainty. It shows the output gap, as measured by the UK's Office for Budgetary Responsibility together with an aggregate index of uncertainty that I have constructed by pooling information from four measures. The first monitors how many UK newspaper articles contain various relevant terms such as "uncertainty", "economic" and "deficit". The second is a measure of financial stress, which looks at volatility in the pound and in the UK stock and bond markets. The third – a measure monitoring stock-market volatility based on pandemic disease developments. The fourth – a gauge of global geopolitical risk.



Let's look back over the recent past.

Uncertainty rose significantly at four points: the 9/11 terrorist attacks of 2001, the 2007 to 2009 global financial crisis, the UK's decision to leave the EU in 2016, and the early

stages of the pandemic in 2020. In all of these periods but Brexit, that uncertainty subsequently widened the output gap between actual demand and potential supply. The measure is ticking up again following the outbreak of war in Ukraine. Research by my colleagues and I at Liverpool University supports the conclusions that can be drawn from the chart, finding that a rise in uncertainty depresses UK economic activity for up to 20 months. Output gaps are often rubbished.

The gap between current demand and potential supply is notoriously tricky to measure. And it would be unwise for monetary policymakers to base decisions on how big, or small, the OBR – or any other body – judges the gap to be. Former MPC member Kristin Forbes and colleagues have also warned that the inflationary impact of positive output gaps, like the one currently estimated by the OBR, is stronger that the equivalent deflationary impact of negative output gaps. Inflation is more than three times the Bank's target – and is set to rise further in the coming months.

All of those factors make us cautious in ascribing too much power to any one measure of the economic outlook. Yet in light of Russia's brutal invasion of Ukraine, it's reasonable to assume rising uncertainty will cause a big drop in the UK's positive output gap over the coming months, opening the door for a swift reversal of inflationary pressures. That ought to provide officials keen for a series of sharp hikes with some food for thought.

The Bank's policymakers are facing one of the toughest challenges since they were granted independence a quarter of a century ago. As Greek scientist Thales of Miletus famously noted that "the past is certain, the future obscure". At few points over recent decades has that statement felt as true as it does today. Yet the MPC must act on the basis that they have a reasonable idea of what might come next. Monitoring movements in measures of uncertainty will not provide policymakers with crystal ball, but it may make the outlook for the UK economy a little clearer.