Economic Perspectives

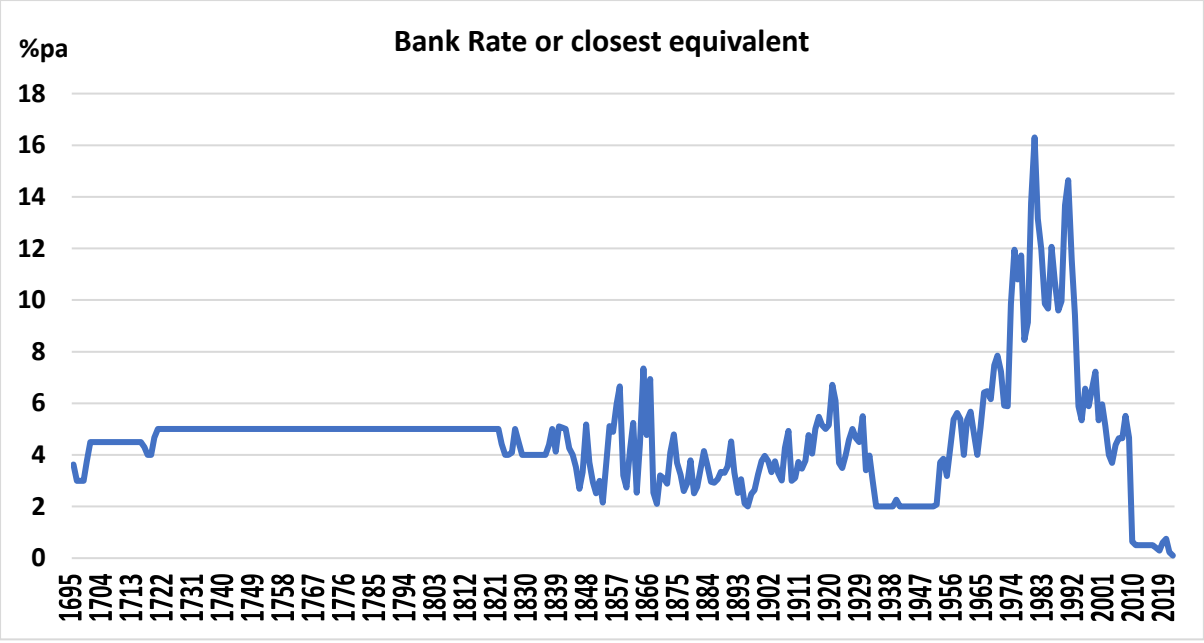
The case for higher, normalised UK interest rates

To begin with the obvious: the interest rate is a price. On one hand it is the cost of borrowing and, on the other, the reward for lending. It is the going rate of exchange for intertemporal money transfers. In a capitalistic economy, borrowing and lending are fundamental to economic growth, the creation of wealth and the distribution of rewards.

A well-developed financial system contains not one interest rate, but many. The interest rates at different borrowing and lending horizons trace out a yield curve. Alongside the government yield curve, spanning the short-term money market and the medium-to long-term bond market, there are yield curves for private borrowers of different degrees of creditworthiness. This transforms the concept of the interest rate from a single number into a matrix of values. However, these rates are closely connected to each other, in the same way that the corners of a rug remain connected, regardless of the way the rug is stretched, folded or twisted.

Viewed as a policy instrument, the short-term interest rate serves a dual function in a market economy, as a restraint on excessive borrowing and as an inducement to save and lend. Ever since the Bank of England was established in 1694, it has maintained an official interest rate (Bank Rate), the rate which other banks and building societies pay for loans from the Bank. As figure 1 confirms, until 2009 this rate had never fallen below 2 per cent; since 2009 it has not risen above 1 per cent and in mid-2021, the modern equivalent of Bank Rate stands at its all-time low of 0.1 per cent.

Figure 1



Data source: Bank of England

Notes: Bank Rate 1694-1972, Minimum Lending Rate 1972-1981, Minimum Band 1 Dealing Rate 1981-1997, Repo Rate 1997-2006, Bank Rate, 2006 onwards. Annual average observations.

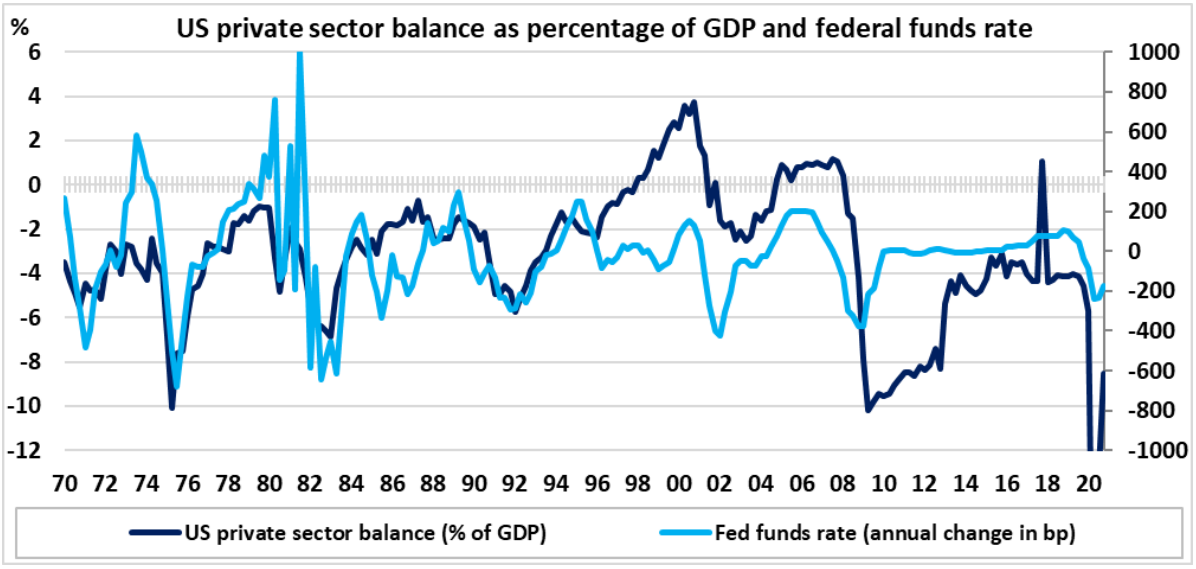
This essay will argue that the collapse of interest rates is a symptom of a deeper financial and economic malaise and that the restoration of short-term UK interest rates to their historical range (of 2 per cent to 5 per cent) is essential to the proper functioning of the market economy. The first section discusses the significance of the policy changes introduced by the Labour government in 1997. In the second section we explore the implications of the new regime for the composition of the primary income of the household sector. A third section identifies increased leverage as a progressively limiting factor on the scope of policy tightening. The following section discusses the obstacles to the normalisation of interest rates and a final section warns of the consequences of a failure to do so.

a. The 1997 monetary policy revolution

In 1997, a momentous decision was taken to hand sole responsibility for the setting of very short-term interest rates to the Bank of England, in the context of charging them to keep the retail price inflation rate within 1 per cent either side of a 2.5 per cent target. While the inflation targeting mandate of the Bank has altered little in 24 years, switching only to a CPI target of 2 per cent in 2003, a dramatic transformation of attitudes and behaviours towards saving, lending and borrowing has occurred since 1997. The assignment of the short-term interest rate to the fulfilment of the inflation objective has biased interest rates to be systematically lower than would be required for efficient capital allocation, with serious implications for financial stability.

It should be stressed, at the outset, that decisions made by the US Federal Reserve, under the chairmanship of Alan Greenspan, were hugely influential in determining the context for the UK policy change in 1997. Arguably, the turning point for US monetary policy was the "tequilla crisis" that arrived in 1994-95, caused partly by the over-issuance of Mexican peso-denominated bonds whose coupons and principal were linked to the US Dollar. In 1995, the US tightening cycle was aborted, seemingly out of consideration for global financial stability issues.

Figure 2

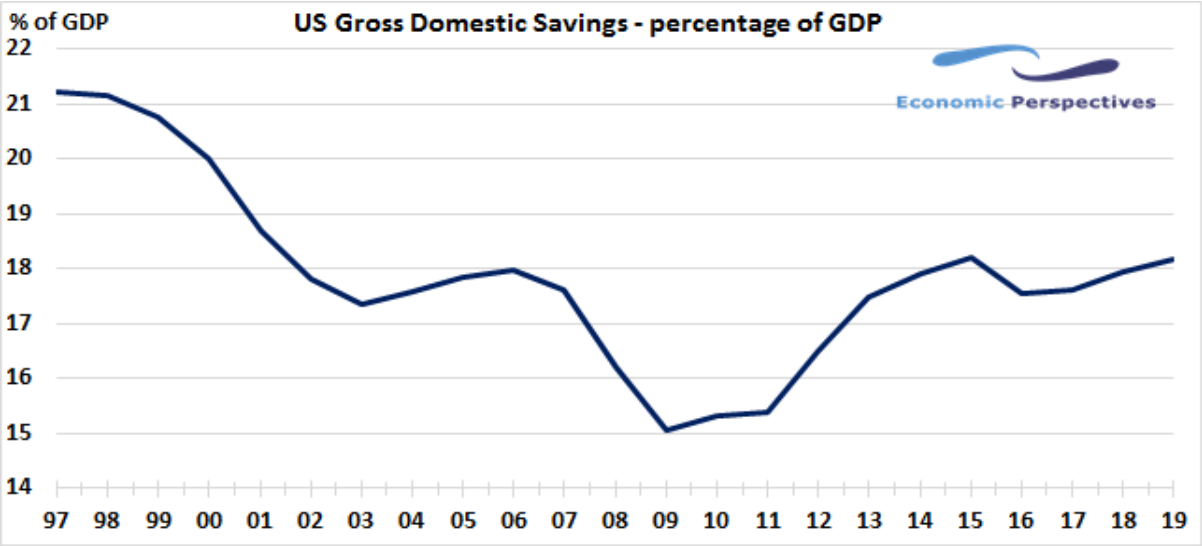


Data source: FRED

Figure 2 shows the close correspondence that prevailed, hitherto, between the scale of the US private sector financial deficit (a measure of economic exuberance) and the one-year change in the Federal funds rate. Each time the deficit rose, the Fed raised its funds rate, and vice-versa. In the second half of the 1990s, as the US private sector (individuals and businesses) plunged deeper into combined financial deficit, US domestic interests would have been best served by the continuation of the aggressive tightening of credit policy. Instead, the Fed baled out after the half-point increase to 6% in February 1995, cutting rates to 5.25% during the following year even as the private spending boom raged on.

Alan Greenspan will be remembered for many things – he has been described as the most famous public servant since Pontius Pilate – but I think of him as the savings saboteur. A consequence of experimental US monetary policy was a fall in the gross domestic saving rate from 21.2% of GDP in 1997 to 15.1% in 2009 (figure 3). The personal saving rate tumbled from around 7% in 1994-95 to 2.2% by July 2005. While the US national saving rate has been rebuilt since the global financial crisis (GFC), the UK experience has been less convincing. In the wake of the pandemic, national saving rates are plunging again (figure 4).

Figure 3



Data source: World Bank

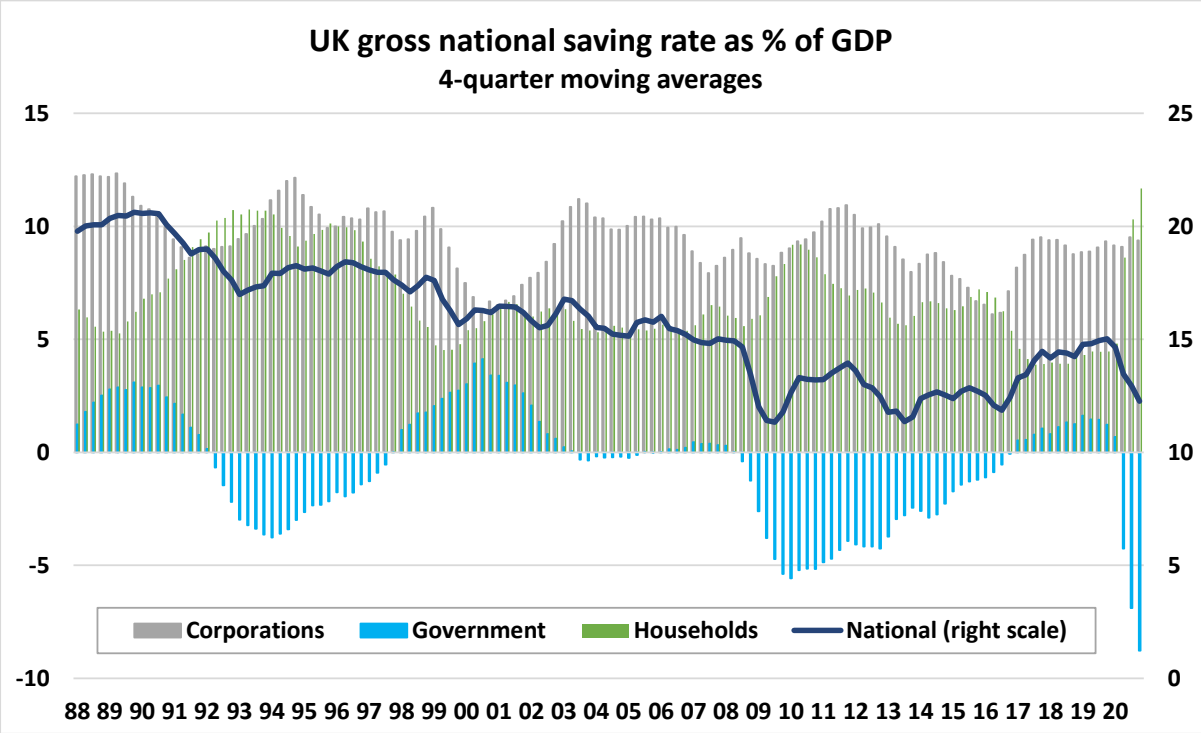
Initially, the source of this bias to historically low interest rates was the massive supply-side shock represented by the progressive integration of Asian producers of manufactured goods into the global trading system. The deflation of imported goods prices facilitated the Bank of England's Monetary Policy Committee's habitual success in hitting its inflation target, for more than a decade.

Indeed, Asian goods price deflation imparted an expansionary bias to domestic credit policy. The prices of domestically sourced goods and services were required to rise faster than the 2 per cent inflation target in compensation for the negative inflation rate of imported goods. The lower the outturns for inflation, the greater the pressure to reduce the policy rate in a bid to restore the inflation rate to target over the coming years.

It is clear from the Treasury's 2002 assessment of the 1997 policy revolution that it was considered a great success: that the framework of budget responsibility and inflation targets had gained credibility and respect in short order. In *Reforming Britain's Economic and Financial Policy*, edited by Ed Balls and Gus O'Donnell, the new monetary policy framework was awarded high marks: "Inflation has been low,

stable, and close to target, while the economy has recorded solid growth and rising employment. The proactive and forward-looking nature of the Monetary Policy Committee, combined with a sustainable fiscal policy, has helped the UK to steer a course of stability and steady growth."

Figure 4



Data source: Thomson Reuters Datastream

Moreover, there was an alleged dividend from the new policy in terms of a lower volatility of national output and inflation. During what was termed the NICE (non-inflationary constant expansion) decade (1997-2007), it was declared that the risk premium embodied in UK official interest rates had fallen. This would enable real interest rates to be permanently lower, making additional leverage affordable and higher real prices of property and financial assets sustainable.

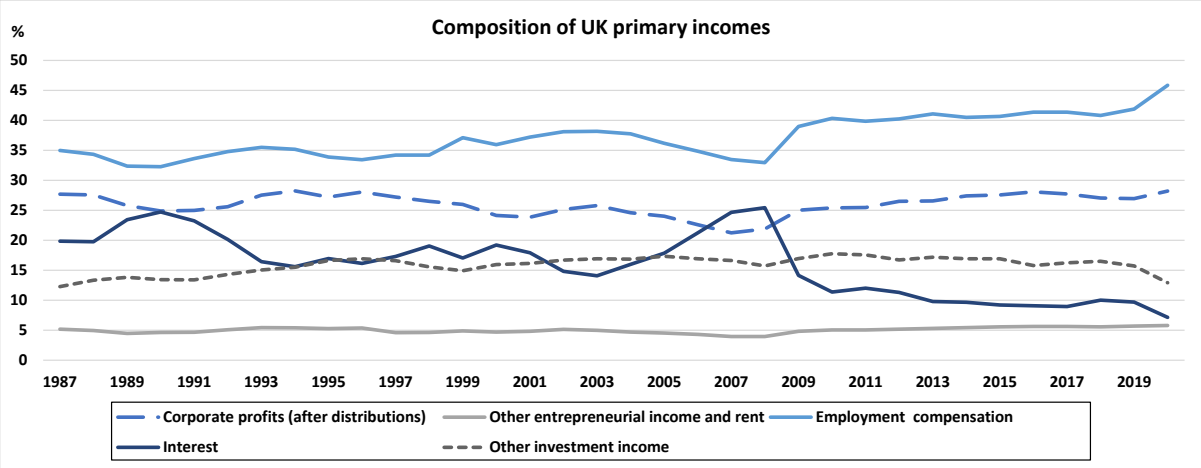
The fundamental flaw in the 1997 macroeconomic policy framework was that systemic leverage became a free variable. When we look back on the financial behaviour of individuals, companies, and financial institutions during 2003-08, we observe a staggering accumulation of leverage in all forms and dimensions. Loan to income multiples in the mortgage market reached as high as 6, quite apart from the prevalence of income self-certification (so-called liar loans). Corporate debt to EBITDA (earnings before interest, tax, depreciation and amortization) ratios reached above 8 for the first time. The leverage ratios of banks and financial institutions soared to well above 50 in some cases. On the way to cashing in the putative dividends from the 1997 policy revolution, private sector balance sheets became extremely fragile. As a result of this vulnerability, the UK experience of the 2008 GFC was among the most severe.

b. The death of interest and the dominance of employment income

If we think about the different types of income in an advanced market economy, then there are five basic headings: employment income, retained income of corporations, other entrepreneurial income (including rent), interest and other forms of investment income. Over long periods of time, it is reasonable to expect that the growth rates of each of these income types would approximate to the

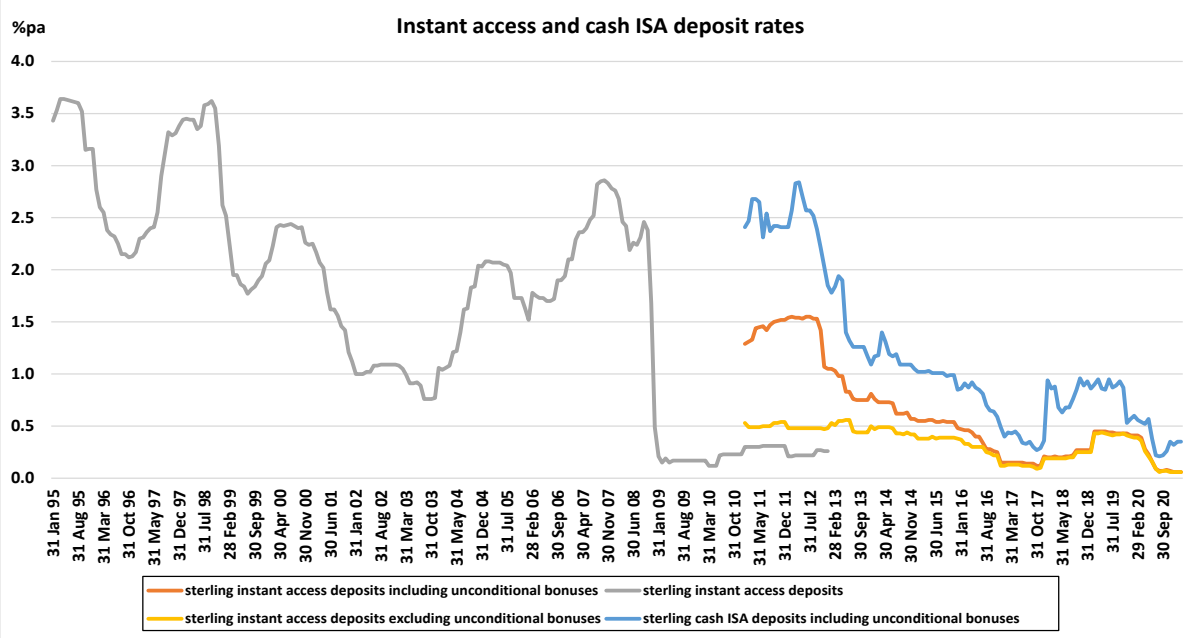
growth of nominal output. In other words, that their shares of national income would be broadly stable over time. Employment income exhibits the least volatility, then corporate profits (after distributions), then other entrepreneurial income and lastly, investment income.

Figure 5



Data source: Thomson Reuters Datastream

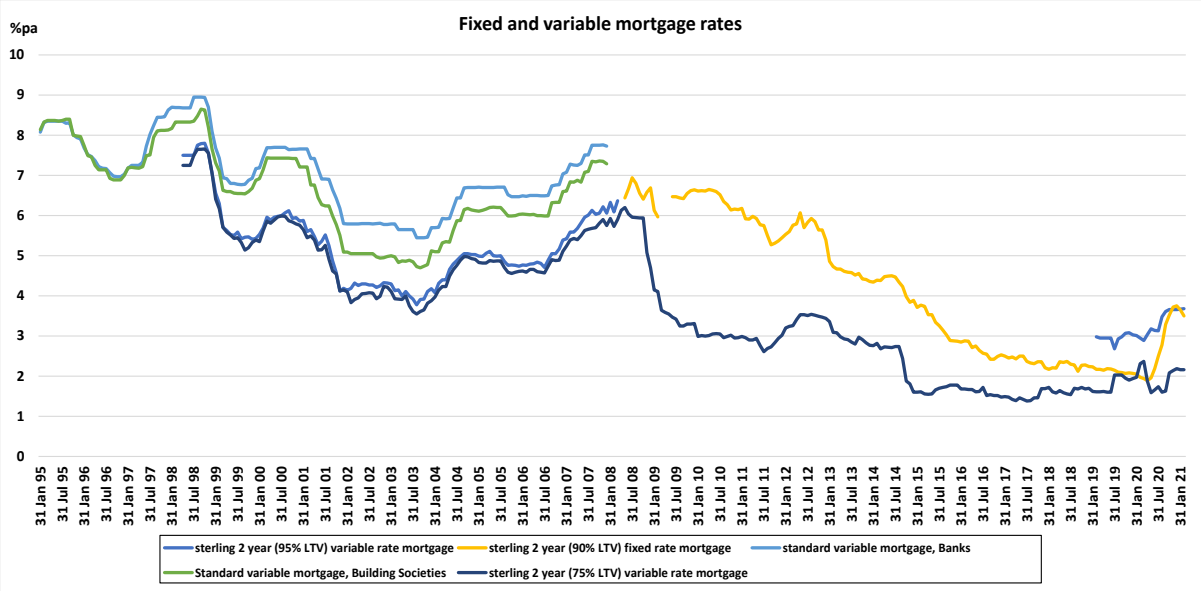
Figure 6



Data source: Bank of England

Figure 5 shows the shares in total UK primary income of these five types of income over a long period. Excluding 2004-08, the speculative interlude that preceded the GFC, interest income has consistently fallen behind other sources of income. This constitutes a cumulative transfer of income from savers to borrowers. Savers have been deprived of the income that they might reasonably have expected to receive, given the growth of aggregate nominal income. Borrowers have gained access to much cheaper loans than would have been typically available based on the historical evidence. This systematic bias has contributed to the widening of income and wealth disparities. The implications for household saving rates and mortgage borrowing rates are illustrated on figures 6 and 7.

Figure 7



Data source: Bank of England

However, this is not the only change that we notice in figure 5. Employment income – wages and salaries and employer's social contributions – has been the primary beneficiary, absorbing most of the lost share of interest income. The UK has enjoyed an employment boom since 1997, notwithstanding the interruption caused by the GFC. The UK adult employment rate was 70.9% at the inception of the MPC in May 1997 but peaked at 76.6% in the 3 months to February 2020, immediately before the pandemic. Headcount employment was fully 25% higher in February 2020 than in May 1997: the UK has been running a 'full employment' policy. The subtlety here is that average real wages have stagnated for much of this period. Households, despite supplying more and more working hours, have achieved only modest improvements in average living standards. Employees, most of whom are also homeowners, have established a pattern of borrowing against the capital appreciation of their property as a means of sustaining higher levels of consumption than their employment incomes would otherwise allow.

c. The coercive power of leverage

After 2 decades of increasing household leverage, the Bank of England became increasingly concerned that the adoption of tighter monetary policy would force a cutback in household spending and a marked slowing in the pace of economic activity. Tightening cycles, in the UK as elsewhere, have become progressively more tentative and shallower, for fear of frightening the horses.

Eventually, the excessive leverage of the financial sector, built on the shaky foundations of wholesale funding at very short maturities, erupted as a financial crisis. What was the Bank of England's response? Why, interest rates must be lowered abruptly, and to their full extent. The Bank Rate, the benchmark nominal interest rate, fell below 1% for the first time in 2009 and it has not yet returned to that level 12 years later.

Slowly, but surely, central banks around the world have been captured by the financial markets: if the reward for reckless leverage is a predictable crisis response of near-zero interest rates, then what is there to fear from unbounded leverage? This is the financial equivalent of the heresy of antinomianism – "let us sin the more, that grace may abound!" The failure of central banks to call financial markets' bluff – by raising interest rates further and faster than expected – can be explained by another subtle

shift in behaviour. Central bankers have become obsessed with their domestic labour markets, inferring that it is their job to prevent unemployment at all costs. With the policy objective function so skewed to accommodation, the threshold of justification for a tightening of policy becomes impossibly high.

d. Obstacles to the normalisation of UK interest rates

If the UK economic and financial system has been bent out of shape by 24 years of misguided monetary policy, is it too late to rectify the error? Has it become impossible to restore interest rates to their proper role as an intertemporal mediator? Is our burden of leverage too great?

I am reminded of Henry Longfellow's poetic aphorism entitled "Retribution":

"Though the mills of God grind slowly, yet they grind exceedingly small;

Though with patience He stands waiting, with exactness grinds He all."

As regards the normalisation of UK interest rates, I fear that we have exhausted the patience of the Almighty, in terms of the very many opportunities afforded to the Monetary Policy Committee to do so. As a founder-member of the Institute for Economic Affairs' Shadow MPC, I have been casting my vote for a rate increase consistently – but not continuously – since 2013.

It seems that the threshold of proof required by a majority of MPC members to approve even a single increase in Bank Rate, let alone a sequence, has become intolerably great. Members have been sitting on their hands for so long, it appears that their voting fingers have become numb. It does not help that central banks around the world have embraced a narrative about the so-called natural or Wicksellian interest rate that regards very low rates as an exogenous phenomenon. Sometimes known by the 3D's – demographics, debt and income distribution – this mindset holds that the equilibrium real – and nominal – interest rate has fallen and that policy rates must reflect this new structural reality.

This essay is not the place for a lengthy critique of this position. Suffice to say, that there is substantial evidence that the choice of monetary policy regime is endogenous to the behaviour of the interest rate. A Bank for International Settlements paper* authored by Claudio Borio and others is probably the best-known critique. Their argument is summarised in the following quote:

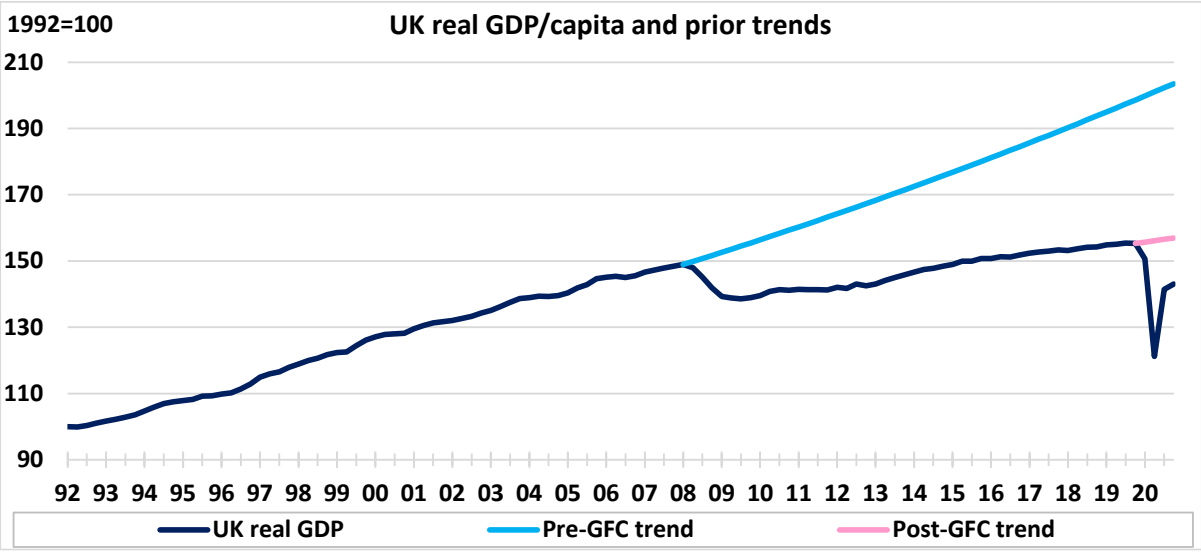
"The role of monetary policy, and particularly its interaction with the financial cycle, deserve greater attention. By linking booms and busts, the financial cycle generates important path dependencies that give rise to intertemporal policy trade-offs. Policy today constrains policy tomorrow. Far from being neutral, the policy regime can exert a persistent influence on the economy's evolution, including on the real interest rate. This raises serious conceptual and practical questions about the use of the natural interest rate as a monetary policy guidepost."

To be explicit: persistently easy credit policies will constrain credit policy in future. When monetary discipline is relaxed over a long period – a decade or more – then there is muscle wastage. Only through the regular exercise of monetary policy muscle is it possible to retain the potential to tighten when necessary.

If policy is calibrated such that the central rule – an explicit inflation target – is achieved effortlessly, as was the case in 1997-2008, then this invites a progressive leveraging of private sector balance sheets. When the long upward march of real GDP per capita was interrupted by the GFC in 2008, the UK economics establishment believed that national output would rebound strongly towards the extrapolation of its prior trend (the light blue line in figure 7) within a few years. It is sobering to reflect

on the cumulative shortfall in real GDP per capita that has evolved since the GFC: 22 per cent by the end of 2019!

Figure 7



Data source: Thomson Reuters Datastream

The dominant framework of thought – in 2008, as today in the wake of the pandemic – remains the Keynesian output gap and the associated inference that the gap is negative, that there is "material spare capacity", in most advanced economies. This judgement – and it can be no more than a judgement – insists that deflation is the greater danger, not inflation. Ergo, a massive new fiscal boost is an appropriate policy response, because it can be expected to have a differentially larger impact on real growth than on inflation.

The notion of a large negative output gap derives from an expectation that real output will return to its prior trend as soon as it is practical to do so. Further, that additional deficit spending is justified in the attempt to drive output back to trend quickly, to avoid scarring or hysteresis. But what if the credit cure is worse than the disease? Surely, the recourse to ever more leverage is the antithesis of sustainability? A rival narrative to the official view is that systemic private sector leveraging supercharged UK economic growth between 1992 and 2008 and the GFC skimmed off the froth. Since 2014, private sector leverage has rebounded once more, yet to much weaker effect in terms of living standards. Has the pace of sustainable economic growth been overstated again? Will the extravagant use of public borrowing in 2020-22 deliver a disproportionately inflationary outcome?

e. Consequences of a failure to restore higher nominal interest rates

What has been lost due to the assignment of policy interest rates to an inflation target? First, the incentive structure that sustains patient capital accumulation through liquid savings and reinvested interest has been torn down. It may not be the end of capitalism, but it is probably the beginning of the end. Historically, the real return on capital has followed the real cost of capital. The longer that policies of financial repression are pursued, the less worthwhile it will appear to take business risk outside the contexts of pseudo-monopoly or as a franchisee of the state.

Second, the discipline inherent in an open capitalistic system has been overriden. Borrowers have become the new aristocracy: their interests must be upheld to maintain public order and avoid a descent into social chaos. The greater the incidence of foolish borrowing, the lower interest rates must

fall for the protection of the foolish. Defaults and bankruptcies are to be prevented at all costs, ultimately by suspending the legal code and enforcing debt forbearance. The proliferation of value-destroying businesses – and their success – pays silent tribute to the phenomenal wastage of capital and the gullibility of investors.

Third, uncollateralised money markets are becoming extinct. Ordinarily, counterparty risk is extremely low within wholesale money markets in advanced economies, in relation to the rewards on offer for very short-term lending. In a well-oiled money market, institutions with cash surpluses lend them out to cash-short institutions at the market rate. This doesn't happen when interest rates fall to zero, or almost zero. Why lend, uncollateralised, to another private sector institution at virtually no interest?

Fourth, and probably the most significant, is that financial stability risks have escalated and multiplied. In March 2020, the Coronavirus pandemic and the suspension of economic life that followed hard on its heels, began to trigger massive capital destruction. Despite all the new regulatory controls and risk monitoring frameworks put in place after the GFC, our highly leveraged financial system was acutely vulnerable. If national governments and their central banks had not intervened, capital values might easily have been marked down by 50% and quite possibly by 75%. A global depression would have become a near-certainty. The effective socialisation of the financial system has restored, and even enhanced, capital values over the past 12 months. As and when the economy is reopened and public supports withdrawn, the aggravation of debt burdens will pose renewed financial fragility risks.

If the normalisation of interest rates will not come as a stream, the danger is that it will come as a flood. The potential reappearance of inflation at annual rates materially above the 2% objective would quickly erode the credibility of policy. Instead of the measured and anticipatory monetary tightening by a policymaker, the UK could be thrust into a world of rising interest rates prompted by distrust and default.

Peter Warburton

6 April 2021 (revised 16 July 2021)

*Borio, C., Disyatat, P. and Rungcharoenkitkul, P., "What anchors for the natural rate of interest?", BIS Working Paper 777, March 2019

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