Economics

QUESTIONS: BREXIT, COST OF LIVING CRISIS AND INTEREST RATES

You are to read the article on *Brexit and interest rates* and answer the questions below on lined paper and bring this with you to your first lessons.
It is expected that you will conduct some research by looking at relevant information online [consider BBC, tutor2u.net] to complete these questions. Look at videos as well as written explanations to acquire knowledge on both of these websites <u>as well as those provided in the article below</u>, this will be the way in which you will complete a lot of independent work as an A Level Economics student. Most questions require a response that involves extended writing and therefore a small paragraph.
Your economics teacher will organise you into small groups so that you can share your notes with other students to work on presentations.

1. What do you understand about the Bank of England?
2. Find out two things about the monetary policy committee
3. Explain how interest rates affect savers and borrowers differently
4. Open the link 'mortgage interest rates' and provide a small paragraph about what you have found out that you did not know before.
5. What have you found out about what is meant by a base rate?
6. Investigate one of the factors, listed in the article that influence the base rate. Pick one of the factors and explain why it contributes to inflation.
7. From your research why do you think the UK voted to leave the European Union and what are your thoughts on whether Governments should use referendums.
8. From your research provide reasons for and against why interest rates / base rates should have been cut?
9. **November 2017: '**there was a fall in the pound'; investigate what this means and then explain why importing things from abroad would be more expensive. You may use a numerical example.
10. **August 2019:** it states there are 'Brexit related uncertainties'. Conduct some research to explain what these uncertainties are. You to provide a small paragraph.
11. Gertjan Vlieghe stated that a 'fall in the pound's value could lead to higher inflation', provide an explanation of why this may be.
12. Read the section on Mortgages. Provide ideas on whether you think a fixed rate mortgage or a variable mortgage is best for homeowners.
13. From your own research by using the websites suggested what has been the cause of rising inflation over the past 18 months in the UK. Question
14. From your own research explain what is hoped will happen by recent increases in interest rates to help bring down the rate of inflation.

BREXIT AND INTEREST RATES

The Bank of England faces pressure to cut interest rates as the UK economy shrinks for the first time in almost seven years, ahead of a possible no-deal Brexit.

Changes to interest rates can have far-reaching consequences, on everything from your personal finances to the wider economy.

The Bank of England sets the interest rate, also known as the **base rate**, in response to current events and expected economic performance to try to keep inflation around its 2% target.

At the start of August, the Bank's monetary policy committee (MPC) voted unanimously to keep interest rates at 0.75%.

But with the Brexit deadline looming ever closer, the Bank will soon have to take action. So what will it do, and what will it mean for you?

Why the Bank of England base rate matters

Sometimes known simply as the interest rate, the Bank of England base rate influences how much banks and other lenders charge you to borrow money, and how much interest is paid on your savings.

In the case of a base rate rise, banks will tend to raise mortgage interest rates as well as loans, pushing up the cost of borrowing money. At the same time, interest rates on savings are also likely to increase, meaning your savings pot could grow a little faster.

Lowering the base rate could have the opposite effect, with mortgage rates becoming slightly cheaper, but savings deals offering lower returns.

After August's growth figures revealed the UK economy shrank by 0.2% – the first contraction since 2012 – many in the City are calling for a rates cut to increase spending and stimulate growth.

- **Find out more:** the Bank of England base rate and your mortgage

Factors that influence the base rate

When setting interest rates, the MPC's goal is to keep inflation as close to 2% as possible. Its decisions are informed by an inflation forecast, which takes into account:

- the current inflation level
- wage growth
- the cost of goods (including the impact of changes in the exchange rate)
- consumer spending
- investment levels

- Interest rate decisions also consider unemployment rates and economic growth figures – the latter of which must not exceed a 1.5% 'speed limit' or inflation could rise above target.
- The Bank of England puts it like this: 'Overall, we know that if we lower interest rates, this tends to increase spending and if we raise rates this tends to reduce spending. So, to meet our inflation target, we need to judge how much people intend to save and spend given the current interest rates.'
- Timeline: interest rates since the Brexit referendum
- As Brexit looms on the horizon, you might wonder how this unprecedented political event might affect the economy. While no one has a crystal ball, it can be helpful to look at what happened to the base rate during the past two years of Brexit votes and negotiations.
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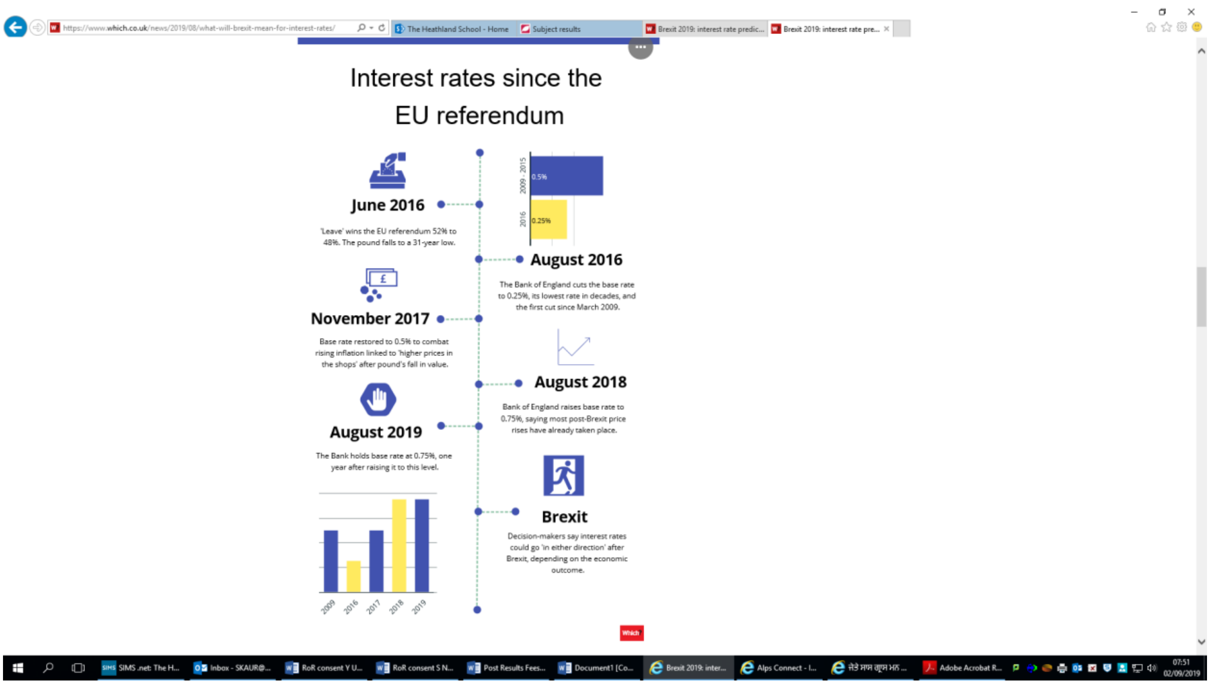

- **August 2016:** Just over a month after the referendum on EU membership, the Bank of England cut the base rate in half – from 0.5% to 0.25%. This was the first time the interest rate had changed since March 2009.
- Interest rates were already at a historic low before this reduction. In the wake of the 2008 financial crisis, the base rate fell dramatically from 5% to 0.5%, where it remained for almost a decade.
- **November 2017:** the MPC restored the base rate to pre-referendum levels in order to combat rising inflation. The Bank linked this decision directly to Brexit, saying 'the fall in the pound following the Brexit vote' means that things from abroad cost more, 'and that means higher prices in the shops'.

August 2018: The MPC raised interest rates from 0.5% to 0.75% – the first rise above 0.5% in almost a decade. This decision was based on the economy's steady growth, and the accompanying report noted that most referendum-related price hikes appeared to have happened already.

March 2019: Just over a week before the UK's original EU exit date of Friday 29 March, the MPC voted to keep interest rates at 0.75% once again, citing low unemployment and inflation almost exactly on target at 1.9%. Minutes from the group's meeting did, however, discuss the negative effect Brexit could have on businesses.

August 2019: Today (1 August), the MPC kept interest rates at 0.75%. Though its summary talked of 'Brexit-related uncertainties', it made the decision based on an economic forecast that included an assumption of a ‘smooth Brexit’. With Mr Johnson committed to an exit, deal or no-deal, this assumption is looking increasingly optimistic.

What decision-makers have said about post-Brexit interest rates

The MPC tends to let is decisions do the talking, rarely revealing what those might be ahead of time. So far, it has taken a ‘wait and see’ approach to Brexit, meaning we might not see any base rate changes until after we leave the EU.

Still, key decision-makers have hinted at what form post-Brexit monetary policy could take:

Mark Carney, governor of the Bank of England

Since the referendum, Carney has been adamant that interest rates could go up or down after Brexit, depending on the circumstances. This was summed up when he said ‘it’s not automatic which way policy would go in the event of a hard Brexit’ at January’s World Economic Forum.

However, at the end of June, he told the Commons Treasury committee that a no-deal Brexit could likely lead the Bank to cut rates.

Gertjan Vlieghe, MPC member

Speaking to the Treasury Select Committee late in February, Vlieghe went slightly further than Carney, saying ‘just because [interest rates] could go in either direction, doesn’t mean that each one is equally likely’.

The rate-setter supported Carney’s point that any interest rate decisions will have to be made in real time, after the committee can see what impact Brexit has had.

Despite this, Vlieghe did outline how a likely fall in the pound’s value could lead to higher inflation, which would require the MPC to take action.

In mid-July he said a no-deal Brexit could see rates cut to almost zero: ‘I think it is more likely that I would move to cut Bank Rate towards the effective lower bound of close to 0% in the event of a no-deal scenario.’

The monetary policy committee (MPC)

In May’s inflation report, the MPC, which includes Vlieghe and Carney, said: ‘Whatever form Brexit takes, we will keep inflation low and support the economy.’

As we saw in 2017 and 2018, the MPC can opt to increase the base rate when they want to lower inflation. However, there will be other factors, such as a potential lack of consumer and business confidence, that the Bank will have to contend with after Brexit.

Minutes from June’s MPC meeting said rates would gradually rise ‘were the economy to develop broadly in line with its May Inflation Report projections that included an assumption of a smooth Brexit.’

But the minutes also said that ‘domestically, the perceived likelihood of a no-deal Brexit has risen,’ which suggests the ‘smooth Brexit’ assumption might soon be retired.

What economists say about interest rates post-Brexit

Rocio Concha, chief economist at Which?

‘It’s clear that the political uncertainty surrounding Brexit is preventing the Bank of England from raising rates beyond their current level. In the medium term though, the Bank’s intention is still to gradually increase rates closer to their pre-recessionary norms – but only if the UK’s departure from the EU goes smoothly.

In the event of a no-deal Brexit, we expect that the most likely response is for rates to fall in order to stimulate a weakened economy. But, as the Bank says, that is by no means certain. A fall in the value of the pound will undoubtedly lead to higher prices and the Bank may find itself in a difficult position, balancing economic stimulus with tackling inflation.’

Ben Brettell, senior economist at Hargreaves Lansdown

Brettell told Which? Money: ‘The Bank of England has been setting a neutral tone as Brexit approaches. The minutes of recent meetings reiterate that the MPC still sees the need for higher interest rates in the coming years, but a deteriorating global growth outlook and mounting Brexit uncertainty have put paid to any thoughts of tighter policy for now.

Where we go from here is highly uncertain, as we still have little clarity over what Brexit will look like, if and when it happens. An orderly Brexit could see the Bank refocus on wage growth and raise rates later this year. A no-deal scenario would likely see sterling fall 5-10%, causing a spike in inflation, but I’d expect the Bank to look through this and cut rates to support the economy.’

What can you do to prepare?

If the Bank of England base rate does change after Brexit, the key things that might be affected are your mortgage and your savings.

Savings

For savings, a base rate rise could see your account’s interest rate increase, giving you better returns. On the other hand, if the base rate is cut, you might see your interest fall.

Switching to a fixed-rate account will secure you against any potential Brexit turmoil, but you’ll miss out on the possible benefits of a base rate rise.

If you’re thinking of switching, you can compare hundreds of savings accounts at Which? Money Compare to find the best home for your nest egg.

Mortgages

Variable-rate and tracker mortgage customers could face higher repayments if the base rate rises. If you’re worried about this, you could remortgage to a fixed-rate deal in order to secure cheaper repayments for a set period.

However, if the base rate is lower, variable rate borrowers may see their repayments become cheaper. You’ll miss out on this if you’re on a fixed rate.