Bank of England’s interest rate rise may cause more harm than good

What a strange world we’re living with where increasing interest rates could be construed as not being tough enough on inflation. Yet that is the world we seem to be living in.

On Thursday, the **Bank of England lifted the cost of borrowing** by another quarter percentage point to 1.25 per cent.

It was the fifth successive increase, taking this benchmark rate to the highest level since 2009.

Inflation set to peak above 11% as fuel prices reach another record high – follow live cost of living updates

For years, central banks talked about the long distant prospect of lifting the cost of borrowing towards “normal” levels. Well, now it is beginning to happen.

But for many, the Bank isn’t moving fast enough.

On Wednesday, its US counterpart, the Federal Reserve, **lifted its benchmark rate by 0.75 percentage points**, so a lot of people expected Threadneedle Street to go further, perhaps lifting rates by half a percentage point. But no.

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Whether or not you think it is taking the right decision rather depends on where you stand on the debate going on at the Monetary Policy Committee, the Bank committee which makes these decisions.

On the one hand, inflation is very high indeed – 9%, and the MPC now thinks it will hit 11%.

This is the highest level since the 1980s, and inflation is one of those problems which can very quickly spiral out of control – especially if wages rise in lockstep and one thing chases another.

On the other hand, the economy is also facing a potential recession; indeed, the Bank's own economists think gross domestic product will contract in the second quarter of the year.

Now, there are some statistical quirks underlying this, since there's an extra bank holiday this quarter.

Even so, there is growing evidence that the UK economy is facing a slowdown at present.

Bank could live to regret these rate rises

Interest rates are a blunt tool. Think of them as a set of accelerator and brake pedals.

Lower rates involves pressing the accelerator, since they encourage people and businesses to borrow and spend more.

Higher rates involves pushing the brakes since they do the opposite thing: encouraging people to save more and spend less.

Inflation often tends to pick up when the economy is racing and drops when it's slowing, so all else equal a rise in interest rates should reduce economic growth and also inflation.

And given inflation is so high right now and interest rates still much lower than they've been for almost all the Bank's 300-plus year history, that would presumably argue in favour of higher rates.

Read more: [How will the interest rate hike affect mortgages?]

But what if the economy is already in recession, or close to it?

In that case, there's a chance the Bank might exacerbate the recession by lifting rates.

There's a chance it may live to regret all these rises and be forced, next year or the year after, to cut them again.

There’s a chance today’s decision (and for that matter the Fed’s decision on the other side of the Atlantic) may cause more harm than good.

So this is not easy.

But overarching everything else is another concern.

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Every time the Bank has come to look at the state of the economy, it has had to increase its inflation forecast. Every single time in the past year.

That’s a worrying pattern, underlining the fact that the Bank is behind the curve, and has yet to catch up with rising prices.

There’s an old analogy in economics, that it’s a central bank’s job to take away the punch bowl full of booze just as the party’s going.

The Federal Reserve has yanked it out of the room quickly; the Bank of England seems to be trying to tiptoe the alcohol out of the room without anyone noticing.