Global Counsel

Marmite for banks

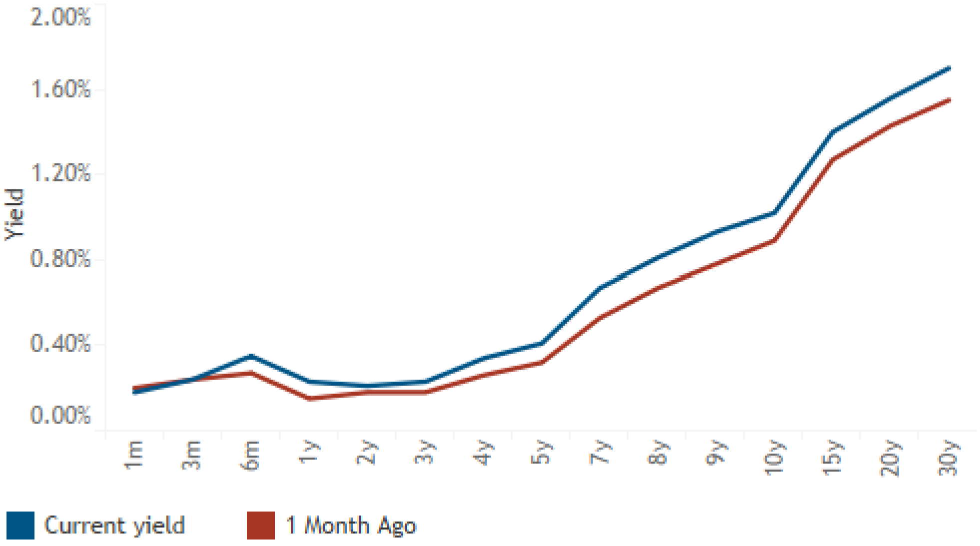
Blog post by Chief Economist Gregor Irwin, 14 October 2016

When British Prime Minister Theresa May addressed her Conservative Party conference earlier this month she railed against the side-effects of super-low interest rates and bemoaned the cost to savers. She promised to fix the problem "because that's what a Conservative Government can do" raising concerns about whether a government that says it is "prepared to intervene" might be about to squeeze the independence of the Bank of England. That is most likely not the message she intended to send. Somewhat ironically, however, her market moving speech, and the economic fall-out from the Brexit vote, may help to produce the conditions that allows interest rates to rise.

The markets' verdict on the speech, widely interpreted as meaning a 'hard Brexit' is now more likely, was rapid, with sterling dropping 6% against the dollar in thin Asian trading and the currency now trading around $1.21, down from $1.48 on referendum day. The macroeconomic implications of that are only now becoming clear. While economists argue over whether the boost to competitiveness will eventually turn around the UK's poor export performance, it is already apparent it will push up import prices and inflation. And there could be no clearer signal of that than the dispute this week between Unilever and Tesco, as the former tried to hike its prices, including the nation's favourite comfort food, Marmite.

This is clearly bad news for consumers as it damages their purchasing power. But is it all bad news for the economy? And just what might it mean for monetary policy and the super-low interest rates that Theresa May is concerned about?

The yield curve of UK government debt



Source: Financial Times

The answer, of course, is that it depends. We know the Bank of England is likely to ignore the step increase in prices that will result from the sterling depreciation, as there is not much it can do about that. The more interesting question is how it responds to signs of this feeding through to future inflation expectations and wage and price dynamics, because that would signal a more permanent impact on inflation. Inflation is, however, well below the 2% target, at just 0.6%, and like other central banks the Bank of England has been desperately short of policy space to deal with that. So might a positive shock to inflation be just what the Bank of England needs?

The sweet spot for the Bank would be if there is enough inflation to allow nominal interest rates to rise, while keeping real interest rates (after adjusting for inflation) low. That won't ease the pain for savers, as it is the real interest rate that matters to them. But higher nominal interest rates would give the Bank of England more policy space to tighten or loosen monetary policy as required, which may be useful given the uncertain impact of Brexit on the economy.

It may also turn out to have a helpful side effect, which is to ease the pressure on high street banks. Unlike investment banks that earn profits from fees and trading, high street banks largely rely on interest income, meaning their profitability is tied not just to the level of nominal interest rates, but the steepness of the yield curve, as they borrow at short maturities while lending long. The steepening of the yield curve seen this month (see Fig) – thanks in no small part to Theresa May's speech – will provide much need relief for Britain's banks. It might even encourage them to lend more to businesses and consumers. A little bit of inflation might turn out to be the banking equivalent of Marmite – and just what the UK economy needs.