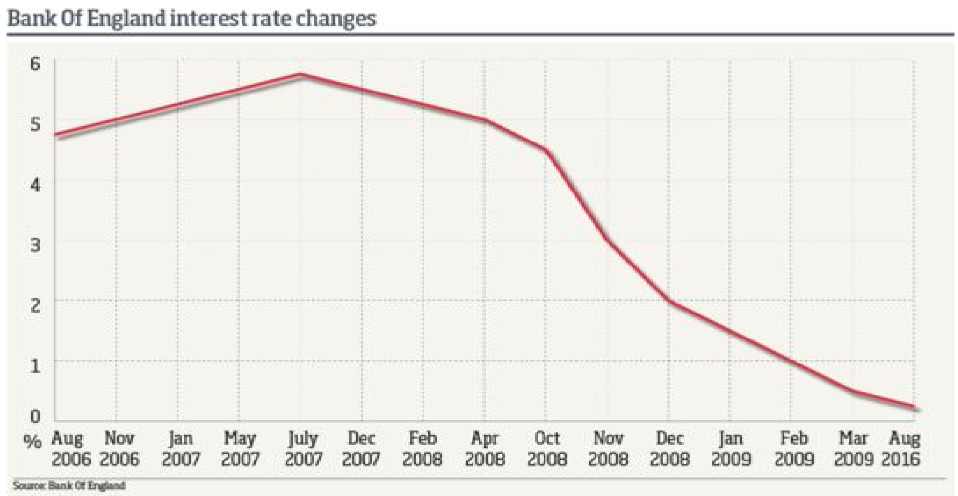
Bank of England's Carney: Two extra rate rises needed to stop economy "running too hot"

Governor Mark Carney has stressed the "gradual pace" of future interest rate increases, with the Bank of England's forecasts based on two more hikes over the next three years.

Following the announcement of the Bank's decision to increase rates from 0.25% to 0.5% today - the first rise in a decade - Carney reiterated the BoE is "easing our foot off the accelerator", after almost a decade of ultra-low interest rates. He said the UK needs to see two further rate increases over the next three years in order to return inflation to its target of 2% and prevent the economy from running "too hot". Carney added that the "sheer novelty of a rate rise creates uncertainty over the impact but we are well positioned for a rate rise".



A total of seven members of the committee voted for an interest rate rise today, while just two members voted for rates to remain at 0.25%. At its last meeting in September, only Ian McCafferty and Michael Saunders had voted for a rise. A statement from the BoE said: "The MPC now judges it appropriate to tighten modestly the stance of monetary policy in order to return inflation sustainably to target. All members agree that any future increases in Bank Rate will be at a gradual pace and to a limited extent," it added.
In particular, the MPC noted challenges to the UK economy, including the ongoing Brexit negotiations.

The rate increase of 25bps places the base rate back to the pre-Brexit referendum level of 0.5%. On the news, Sterling dropped sharply following the announcement, falling 1.1% to $1.31, while the FTSE 100 climbed 0.74% to 7,544 points.

Today's increase is a reversal of the rate cut Bank of England governor Mark Carney implemented last year in the wake of the Brexit vote, which rocked markets and caused sterling to plummet.

The move itself isn't so much surprising as the market had become resigned to the likelihood of a hike since early September. What the markets were having to deal with before the meeting was the question of whether this move was just an acknowledgement to get back to this 0.5% level and hold at this for the intermediate future, or whether it heralds the start of a tightening cycle from the BoE. The economic metrics on the ground certainly don't support a tightening cycle. Wage growth remains relatively stagnant, certainly a long way behind the official inflation figures, and this is coupled with rising consumer debt loads.

This is the first time rates have been raised since July 2007, when they were increased by 0.25% from 5.5% to 5.75%. However, as the global financial crisis began to unfold the BoE, then led by Mervyn King, rates began moving downwards and on 8 October 2008 central banks around the world cut rates in a coordinated move as the crisis peaked. Since March 2009, rates have been at or under 0.5%.

Today's move had been widely predicted by the market and economists following more hawkish comments by governor Mark Carney in recent months as he hinted at hikes 'in the coming months'. CPI inflation rose to 3% in September and the UK economy grew by 0.4% in Q3, giving further reason for economists to increase the likelihood of a rate rise to 84%.

However, speaking to the Treasury Select Committee in October, Carney ruled out raising rates for the sake of it in order to be able to reduce them if there was another recession. "Building a war chest in interest rate terms for a potential future shock, is not staying on point in terms of the inflation target, nor is it appropriate or necessary given that policy can move quite nimbly if required," he said.

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Market forecasts are for the base rate to be somewhere around 1% by the end of 2019, so only two more hikes (following this one) over the next two years. The BoE are appearing to try to wrestle back some degree of control of their forward guidance, and show a little more hawkish stance than the markets are pricing in, in an effort to control inflation.

This is a dangerous policy to adopt, but one that is entirely expected given the farce surrounding the emergency 25bps cut they agreed to last year post-referendum, as the effect of that was to import much higher levels of inflation than would have been the case otherwise. Right now the hike seems to have had the opposite effect with sterling falling close to 1% against the dollar and 10 year gilt yields falling to 1.27%.

The next Bank of England MPC meeting will be held on 13 December 2017.

Information valid at 2 November 2017.
Tax regimes, bases and reliefs may change in the future.

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