The Bank of England raises its key interest rate and leaves the door open
The ECB opts for the status quo, but signals a probable hike for June

According to the Bank of England:
- In the United Kingdom, the Bank of England raised its key interest rate from 5.25% to 5.50%.
- Growth remained firm and should continue at a sustained pace.
- Lower prices for gas and electricity should bring inflation back in line with the medium-term target of 2.0% by the end of the year, but surplus margins are limited.
- Risks related to inflationary perspectives remain oriented upward.

According to the European Central Bank:
- In the euro zone, the ECB is keeping its key rate at 3.75%.
- Heightened vigilance is necessary to ensure that the risks threatening price stability do not materialize in the medium term.

Commentary:

Bank of England (BoE): In a much-anticipated move, the BoE raised its key interest rate to 5.50% at its May meeting. Inflation over 3% in March (and probably April as well) made it necessary for the BoE to write to the British Chancellor of the Exchequer in order to outline the measures it would be taking to contain inflation. An increase in the price of money was a given.

For the moment, there is nothing to indicate that this morning’s hike will be the last. According to the BoE, although it was expected that inflation would approach the 2% target by the end of the year, inflation risks remain oriented upward. It should be said that economic growth is in line with, or above, its potential for the last six quarters. Home prices continue to evolve upward and the job market is very healthy. We will know more once the report on inflation comes out (May 16, 2007), but the door remains open for subsequent hikes this summer.

European Central Bank (ECB): In keeping with its current monetary policy of progressive tightening (approximately one hike every three months), the ECB maintained the status quo at 3.75% this morning. However, it clearly signalled its intention of raising its key rate again. According to the ECB, heightened use of production capacity, an additional increase in oil prices, strong growth in credit and a possibility of stronger than anticipated wage increases are contributing to keeping inflation risks high. Consequently, the ECB reintroduced the notion of “strong vigilance” in its statement, signalling unequivocally that it would raise its key rate to 4.00% in June.

Although we are expecting inflation to remain contained until the end of the year, the continued economic vitality in the euro zone leads us to believe that the June increase won’t be the last. In our opinion, the ECB will push its monetary tightening to 4.25% at the end of the summer. What follows will depend on economic conditions. If it seems the U.S. Federal Reserve will have to lower its key rate in order to counter difficulties related to the American real estate market, upward pressure on the euro could be such that the ECB would have to opt for a prolonged status quo in the fall.
The Bank of England’s Monetary Policy Committee today voted to raise the official Bank Rate paid on commercial bank reserves by 0.25 percentage points to 5.5%.

In the United Kingdom, output growth has remained firm. Business investment has been stronger than expected and, although indicators of consumer spending have been volatile, the underlying picture is one of steady growth. Credit and broad money continue to grow rapidly. The pace of expansion of the international economy remains robust.

CPI inflation picked up to 3.1% in March. Lower gas and electricity prices and weaker import price inflation mean that CPI inflation is likely to fall back to around the 2% target in the course of this year. But the margin of spare capacity in firms appears limited and there are signs that businesses are more able to push through price increases. Relative to the 2% target, the risks to the outlook for inflation in the medium term consequently remain tilted to the upside.

Against that background, the Committee judged that a further increase in Bank Rate of 0.25 percentage points to 5.5% was necessary to meet the 2% target for CPI inflation in the medium term.

Excerpt from the Bank of England press release
May 10, 2007