As expected, the Bank of England raises its key rate to 5.0%

According to the Bank of England:

- The official Bank Rate paid on commercial bank reserves has been raised 25 basis points to 5.0%.
- The economy has recorded its fourth consecutive quarter of firm growth.
- Although unemployment has continued to rise, spare production capacity remains slim.
- Oil prices have fallen, but there are signs that other price pressures have picked up.
- In the near term, inflation should rise further above the target, but will subsequently drop back as energy and import prices diminish.

Commentary:

This morning’s decision was widely expected. For one thing, the economy expanded at a quarterly annualized rate of 2.8% this summer, its strongest growth in two years. For another, inflation risks continue to exist. In spite of the drop by energy prices, the recent increase in core inflation, which excludes the impact of energy and food, shows that other sources of inflation pressure are surfacing. With total inflation (2.4% in September) above the Bank’s target of 2.0%, it comes as no surprise that committee members found it necessary to increase the key rate so as to bring inflation back into line with the target in the medium term.

In our opinion, there is a good chance the Bank will raise its key rate once again, to 5.25%, in early 2007. Note that the housing market has come back strongly in the last year. Annual growth by home prices accelerated to over 8.0% in September, which should support households’ consumption spending in the coming quarters. With the recent increase in consumer credit, it is likely the Bank of England will remain concerned about inflation. What’s more, the forward market already seems to be positioned for this possibility.
[...] The UK economy has recorded its fourth consecutive quarter of firm growth. Household spending has been volatile, but the underlying picture appears to be one of moderate expansion. The recovery in business investment has been maintained. The outlook for growth in the United Kingdom's main export markets remains positive. Credit and broad money growth remain rapid, and asset prices have continued to rise.

Although unemployment has continued to edge up, the margin of spare capacity within businesses appears limited. Oil prices have dropped back, but there are signs that other pricing pressures have picked up. CPI inflation was 2.4% in September. It is likely that inflation will rise further above the target in the near term, but then fall back as energy and import price inflation abate.

Against that background, the Committee judged that an increase in Bank Rate of 0.25 percentage points to 5.0% was necessary to bring CPI inflation back to the target in the medium term. [...] 

Excerpt from the Bank of England press release
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