Bank of England Raises Rates Another Half a Point at an Uncertain Time

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FULL TEXT

Britain is fighting inflation, which is running near its fastest pace in decades. Policies to cap energy costs and cut taxes complicate the outlook.

As Britain goes through a period of vast change, with a new government and new monarch, the central bank is steadily increasing interest rates to try to keep high inflation from becoming embedded in the nation's economy.

The Bank of England raised its key rate another half a percentage point on Thursday, to 2.25 percent, taking it to the highest level since late 2008 but disappointing some who had thought it would make a three-quarter-point move. In Britain, consumer prices rose 9.9 percent in August from a year earlier, slowing slightly from the previous month but still near the fastest pace of inflation in four decades, as energy and food prices climbed higher.

The British economy's state of flux was evident in a rare three-way split among the Bank of England's nine-person rate-setting committee, with members voting for both smaller and larger increases in the policy rate.

The changes coming to Britain include the government's freezing energy bills and planning to cut taxes to lessen the pain of the higher cost of living. At the same time, the pound has fallen to its weakest level against the dollar since 1985 as investors question the country's economic outlook and fiscal policy, and despite a tight labor market, a recession seems inevitable. The Bank of England forecast that the economy would contract slightly in the third quarter, after a drop in the second quarter, which is widely considered to indicate a recession.

Five of the bank's policymakers voted to increase rates half a point, the same move as the previous meeting; three wanted a more aggressive increase of three-quarters of a point; and one person voted for just a quarter-point increase, arguing that economic activity was already weakening and that future inflation risks were waning.

The vote split "reflects a very uncertain economic outlook," Stefan Koopman, a strategist at Rabobank, wrote in a note to clients.

Policymakers also voted to start selling the bank's holdings of British government bonds back to the market, entering uncharted territory after more than a decade of growing its balance sheet by buying bonds to keep market interest rates low and provide easy money to lenders.

Since the bank's last policy meeting in August, major changes to government strategy have altered the outlook for inflation. This month, a new government, led by Prime Minister Liz Truss, took over. Amid concerns about the ruinous impact of rising energy costs, the government has moved to cap bills for households and businesses. The immediate effect is that inflation is expected to peak sooner and at a much lower rate.

The Bank of England said it expected the annual inflation rate to peak at just under 11 percent next month —the freeze on household energy bills has lowered its forecast for the peak by about five percentage points. Still, the bank said it expected inflation to rise above 10 percent over the next few months before it started to retreat. It targets a 2 percent inflation rate.

But the government's expansive energy policies and its broader fiscal plans, which include a package of tax cuts and hopes of quickly increasing economic growth, have the potential to raise longer-term inflationary pressures. Formal announcements on taxes aren't expected from the Treasury until Friday, and the Bank of England said it would make a full assessment of the impact for the November policy decision.

"Should the outlook suggest more persistent inflationary pressures, including from stronger demand, the committee will respond forcefully, as necessary," according to the minutes of the bank's policy meeting. The bank's meeting was delayed a week by the mourning period for Queen Elizabeth II.

Since December, the Bank of England has raised rates seven times, starting with a record low of 0.1 percent. Other major central banks started raising rates later but have since moved in larger increments.

On Wednesday, the Federal Reserve raised its key rate three-quarters of a point for the third meeting in a row, to a range of 3 to 3.25 percent. Six months ago, rates in the United States were near zero. The European Central Bank, which began raising rates from below zero in July, increased its rate three-quarters of a point this month. The Swedish central bank surprised economists by raising its key rate a full point on Tuesday, and earlier on Thursday Switzerland's central bank raised its rate three-quarters of a point, ending its yearslong stretch of negative interest rates.

On Thursday afternoon, after the Bank of England's policy announcement, the pound was weaker against the dollar, trading at about $1.12, its lowest level since 1985. The dollar's strength is hammering currencies around the world as the Fed quickly raises rates, undeterred by the economic pain it might cause, which has encouraged investors to flock to the haven currency. (Japan's government said on Thursday that it had intervened for the first time in 24 years to prop up the yen, which was once a traditional haven, too.)

The pound has weakened about 17 percent this year against the U.S. currency but has also shown broad weakness against most other major currencies. The prices of British stocks and bonds have also been also falling, as investors question whether the government's policies will be able to sustainably grow the economy.

The Bank of England forecast that the economy might already be in recession, predicting gross domestic product would fall 0.1 percent in the third quarter. It had previously forecast growth of 0.4 percent. The economy shrank slightly in the second quarter.

Last month, the bank predicted that the economy would weaken all through next year as household incomes were significantly squeezed by high inflation, which would put the country in its longest recession since the financial crisis in 2008. On Thursday, it didn't provide any update to this view in light of the government's energy policies and tax plans, which it said were likely to have a "material" impact on the country's economic outlook.

The policymakers who voted for a half-point rate increase, including the bank's governor, Andrew Bailey, argued that the tight labor market, with a larger-than-expected share of people out of work and not looking for jobs, and wage growth running above the levels consistent with the bank's inflation target warranted a "further, forceful" increase in rates. The freeze in household energy bills meant demand was likely to be higher than previously expected, they argued, adding that the freeze wouldn't be enough to bring down expectations of high inflation on its own.

The three members who voted for a three-quarter-point increase said they wanted to reduce the risk of a "more extended and costly tightening cycle later," arguing that there were already more persistent inflationary pressures and that expectations for future price increases remained high.

The committee's newest member, Swati Dhingra, an economics professor at the London School of Economics, voted in her first meeting for a quarter-point increase, judging that some of the consequences of high inflation, for example on services prices, would fade. But she did concede that pressure from demand could increase, for reasons including the expected changes to fiscal policy.

These policies, which the government has yet to provide official cost estimates for, are expected to lead to a large increase in the amount of bonds the government will need to sell to raise money to subsidize energy bills for households and businesses. The Office for Budget Responsibility, an independent watchdog, said the measures would "raise borrowing significantly" over the next six months.

The Bank of England policymakers did unanimously agree to start selling government bonds back to the market, increasing the supply of British debt on offer to private investors. Over the next 12 months, the bank will reduce its holdings of bonds by £80 billion through sales and redemptions, to £758 billion. There will be a high bar for altering this plan, the bank said.

"The Bank of England can, however, only maintain such a relatively gradual pace of interest rate increases," Mr.

Koopman of Rabobank wrote, “if Truss and her team are able to reassure markets that she has a plan on how she will eventually provide balance in public spending.”

DETAILS

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