CENTRAL BANKS

Bank of England raises its benchmark rate by 75 basis points, its biggest hike in 33 years

PUBLISHED THU, NOV 3 20228:00 AM EDTUPDATED 16 MIN AGO

Elliot Smith
@ELLIOTSMITHCNBC

WATCH LIVE
SHARE

KEY POINTS

- The 75 basis point increase takes the Bank Rate to 3%, its eighth consecutive hike to the main lending rate.
- Economists had anticipated the less hawkish tone from the central bank after the change in the U.K. government.

A passageway near the Bank of England (BOE) in the City of London, U.K., on Thursday, March 18, 2021.

Hollie Adams | Bloomberg | Getty Images

LONDON — The Bank of England on Thursday raised interest rates by 75 basis points, its largest single hike since 1989, and warned of a prolonged recession as

policymakers looked to temper market expectations for further aggressive monetary policy tightening.

The 75 basis point increase takes the Bank Rate to 3%, its eighth consecutive hike to the main lending rate, after the Monetary Policy Committee voted 7-2 in favor. One member voted for a 0.5 percentage point rise while one preferred a 0.25 increase.

However, the Bank appeared to challenge the market's pricing of future rate rises.

"The majority of the Committee judges that, should the economy evolve broadly in line with the latest Monetary Policy Report projections, further increases in Bank Rate may be required for a sustainable return of inflation to target, albeit to a peak lower than priced into financial markets," the MPC said, offering uncharacteristically specific guidance to the market.

The MPC noted that its updated projections for growth and inflation indicate a "very challenging" outlook for the U.K. economy as it looks to bring inflation back toward its 2% target.

U.K. GDP is projected to decline by around 0.75% over the second half of 2022, reflecting the squeeze on real incomes from surging energy and tradable goods prices.

Prolonged recession

Conditioned on the elevated path of market interest rates, growth is projected to continue to fall throughout 2023 and the first half of 2024, as "high energy prices and tighter financial conditions weigh on spending," the Bank said. This would be the longest recession since comparable records began. Unemployment is expected to rise to 6.5% by 2025.

As well as a prolonged period of recession, a significantly worse economic performance than that seen in the U.S. and euro zone, the Bank also expects no growth in labor productivity and a fall in business investment.

Bank of England Governor Andrew Bailey reiterated in a press conference following the announcement that "the central projections conditional on the market implied path of bank rate serve as a reminder that we should not increase Bank Rate too far."

"The MPC judges that the path of the Bank Rate required to return inflation sustainably to target is shallower than that priced into financial markets," he added.

Economists had anticipated a less hawkish tone from the central bank after the change in the U.K. government. New Prime Minister Rishi Sunak's likely return to a more conventional fiscal policy after the brief and chaotic tenure of predecessor Liz Truss calmed the markets and meant that monetary and fiscal policy were no longer pulling in opposite directions.

VIDEO 09:32

How 'trickle-down economics' backfired on Britain's shortest-serving prime minister

Inflation spiked to 10.1% in September and is expected to rise to 11% in the fourth quarter, the Bank said, though it expects consumer price increases to fall from early next year as the energy price falls out of the annual comparisons. In its central scenario conditioned on market implied rate paths, inflation falls below target by the second quarter of 2024.

Meanwhile mortgage rates have risen sharply on higher interest rate expectations, placing further strain on households.

"For the current November forecast, and consistent with the Government's announcements on 17 October, the MPC's working assumption is that some fiscal support continues beyond the current six-month period of the Energy Price Guarantee (EPG), generating a stylised path for household energy prices over the next two years," the MPC said.

"Such support would mechanically limit further increases in the energy component of CPI inflation significantly, and reduce its volatility. However, in boosting aggregate private demand relative to the August projections, the support could augment inflationary pressures in non-energy goods and services."

Sterling dropped 2% against the dollar after the decision to trade around $1.116, while U.K. government bond yields rose.

After its emergency bond-buying intervention last month prevented the possible collapse of the U.K.'s pension fund market, in light of plunging government bond prices caused in large party by Truss' fiscal policy announcements, the Bank of England revived its plan to start selling gilts (U.K. sovereign bonds) — which commenced on Tuesday.

'Little choice' but to meet market expectations

All eyes will now turn to Finance Minister Jeremy Hunt's fiscal statement on Nov. 17, where the government will need to "strike a fine balance between supporting the economy and a credible medium-term plan for debt consolidation," according to Hugh Gimber, global market strategist at JPMorgan Asset Management.

Gimber suggested the Bank had "little choice" but to deliver on the market's expectations of a 75 basis point hike on Thursday.

VIDEO 02:50

BOE's Bailey: UK economic shocks differ from those in the U.S.

"Such a large hike may appear unwarranted given signs that U.K. activity is already contracting, but there is scant evidence as yet that the slowdown is sufficient to tame inflation," Gimber said.

"Open job vacancies continue to exceed the number of people looking for employment and wage growth at 6% is far above the level that would be consistent with the Bank's inflation target."

However, he also suggested that a more modest hike against a backdrop of double-digit inflation, and following aggressive action from the U.S. Federal Reserve and the European Central Bank, would have risked "reigniting questions about the Bank's credibility and further volatility in sterling markets."

The Fed on Wednesday approved a fourth consecutive three-quarter point hike, taking its short-term borrowing rate to a target range of 3.75%-4%, its highest level since January 2008.

The ECB last week also implemented a 75 basis point hike, taking its main benchmark to 1.5%, a level not seen since 2009.

"Going forward, the Bank's tightening will not need to go that far, as the energy price shock will contribute significantly to demand destruction – the impact has already started to materialise," said Silvia Dall'Angelo, senior economist at Federated Hermes.

"In addition, the government's fiscal announcement on 17th November will likely deliver some significant fiscal tightening. While the Bank was not able to incorporate that information in its forecasts today, that implies downside risks to an already downbeat set of growth forecasts."

Squawk on the Street WATCH IN THE APP
UP NEXT | TechCheck 11:00 am ET