The impact of Interest Rates

ACCA

Interest rates are set by the Monetary Policy Committee (MPC) of the Bank of England. The MPC is tasked with keeping inflation to the limits set by the Chancellor.

High inflation erodes the value of money as you pay more but get less. This makes the electorate unhappy and consequently the Government are keen to keep inflation down. The role of the MPC is to maintain interest rates at a level that keeps inflation under control.

A little inflation is good as it gradually increases asset values such as house prices. The opposite of inflation is deflation. The price of goods and services constantly reduces which means that consumers don't buy as they are waiting for goods to get cheaper and cheaper. Ultimately demand dries up, industry falters and the economy grinds to a halt.

If the interest rate goes up the cost of borrowing to companies increases. This reduces their profitability. This is one reason why their share price tends to go down. An increase in interest rates also reduces the value of corporate bonds. The rate of interest the bonds pay is less attractive because interest rates have gone up.

This also impacts on UK exports. Foreign institutional investors bring money into the UK to get the benefit of the increased interest rate and convert their cash into sterling to deposit in banks. This drives up the price of the pound in the forex market. As a result UK exports to overseas markets become more expensive to buy as the local currency has devalued compared the pound. So UK exports decline.

If the MPC reduces interest rates than the opposite happens.

	Interest Rates ↑	Interest Rates ↓
Value of pound sterling	↑	↓
Impact on UK exports	↓	↑
Cost of corporate borrowing	↑	↓
Company profits	↓	↑
Company share prices	↓	↑
Value of corporate bonds	↓	↑

Source:
Stoakes, Christopher, 2007/8, All you need to know about commercial awareness, Longtail.