INVESTMENT FUNDAMENTALS

What is the Official Bank Rate?

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Snapshot

- The official bank rate is an interest rate set by the Bank of England for secured overnight lending to major banks.
- The Bank of England's strategy around setting the official bank rate requires a delicate balancing act.
- Changes made to the official bank rate have implications for the broader UK economy.

It's no mystery that UK markets are sensitive to the official bank rate, an interest rate set by the Bank of England (BoE) for secured overnight lending to major banks. An adjustment to the rate only needs to be anticipated—not actually made—for the markets to react. And sometimes it's a lack of change that drives market volatility.

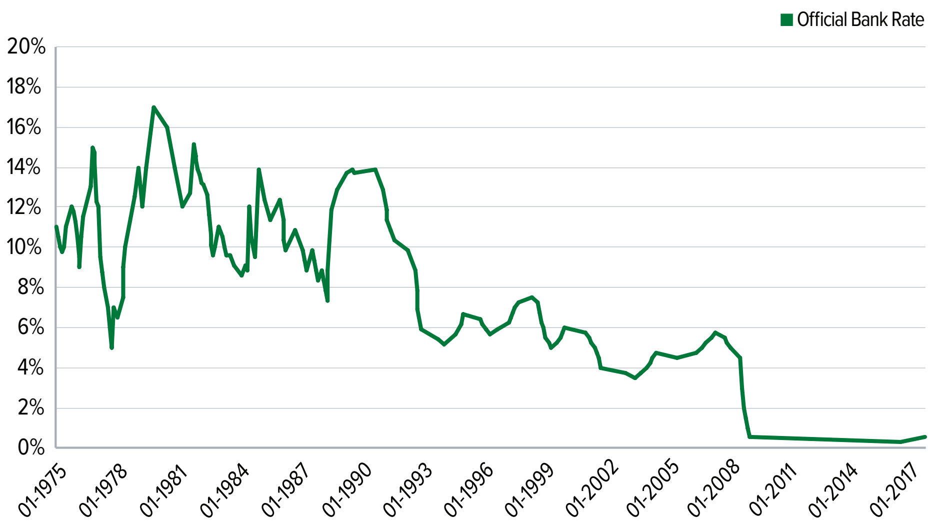
But what remains a mystery to many is what exactly the official bank rate is, how it's set and why its movements (or lack thereof) can have such a profound effect on market activity.

Putting the "Official" in Official Bank Rate

The BoE is the UK central bank where the country's money supply and interest rates are managed. Among other functions, the central bank is intended to act as the government's bank, issue currency and oversee monetary policy.

The official bank rate (Exhibit 1) used for overnight lending is set by the Monetary Policy Committee (MPC), a committee within the BoE, which typically meets eight times a year to review economic and financial conditions.

Exhibit 1: Official Bank Rate



Source: Bank of England, SEI.
Data as of 28/4/18.

The MPC's strategy around setting the official bank rate requires a delicate balancing act—typically based on the conditions of two factors: achieving maximum employment and price stability. If employment is weak, for example, the rate might be lowered to spur economic growth, as inexpensive borrowing costs would make job-creating activities more feasible for established companies and entrepreneurs. However, in weighing whether or not to lower the rate, the BoE must consider that doing so might fuel inflation (or rising prices), since the supply of borrowed money available for spending would expand.

On the other hand, if the primary concern of the BoE is inflation, it might increase the official bank rate in order to slow price increases (by reducing demand for borrowed money). But a consequence of this is that job creation may suffer.

BoE: Setting the Tone

The BoE's need to execute such a delicate balancing act shows that the official bank rate affects more than overnight borrowing at the BoE—it also has implications for the broader UK economy. In fact, the official bank rate serves as a reference point for most other short-term financing activity in the UK.

Changes in the official bank rate set off a series of events that affect a range of economic variables, including short-term interest rates, foreign exchange rates and credit. It also impacts the labour market and the prices of goods and services. Essentially, the official bank rate has downstream consequences that influence the entire UK economy.

What it Means for You

What should you do in the face of potential market volatility around interest-rate activity? First, know that volatility is an expected, if unpredictable, part of investing and is as dynamic as the market itself. Second, as always, stay focused on your long-term investment objectives. While stocks frequently feel pressure when the BoE raises interest rates, historically they have made up for this in the long term. Overreacting by selling investments could result in missing out on gains when the market bounces back.

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