



# Interest Rates

A very interesting subject

# What is an interest rate?

- An interest rate is the compensation that a borrower will pay to a lender for the use of their money.
- The actual rate payable is dependent on the terms of the loan.
- Terms will include the amount involved, time for repayment and security of the loan.

# Examples

- Bank of England Base Rate – 4.50%
- Halifax standard variable mortgage rate – 6.50%
- Halifax unsecured loan rates – 7.9% - 18.9%
- Halifax credit card rate – 15.9%
- Halifax Liquid Gold Account – 0.70%
- Halifax unauthorised overdraft – 29.8%

# How are rates set?

- Since it was set up in 1997, the Monetary Policy Committee meets at the beginning of each month to discuss the economy and sets rates in accordance with the latest financial data.
- The prime objective of the committee is to set rates that will enable inflation to be controlled within Government guidelines.

# Monetary Policy Committee

- The Monetary Policy Committee has 9 members including the Governor of the Bank of England.
- They consider the economic data that has been published since the previous meeting and how the various factors will effect the economy.
- From this they set the Bank of England Repo rate at a level that they feel is most likely to keep inflation within the Government targets.

# What is inflation?

- Inflation in this context is the measure of change in cost of buying an item.
- Historically, we have used the Retail Price Index, which is based on the cost of buying specific items according to popular demand.
- The items are changed periodically to reflect current buying tastes.

# Consumer Price Index

- In December 2003, the Monetary Policy Committee was directed to change the target inflation measure from the Retail Price Index to the Consumer Price Index.
- This was ostensibly done to bring the UK in line with Europe for this type of statistical information.
- The main difference between the two indices is that RPI includes housing related costs.

# The effects of interest rates

- Nobody is immune from the effect of interest rates.
- People with money want to obtain the highest interest possible.
- People borrowing want the lowest rates possible.
- A difficult balance to achieve.

# Interest Rates and Exchange Rates

- There is no strict correlation between interest rates and exchange rates, although there may be occasions when one will effect the other, such as the Exchange Rate Mechanism crisis in 1993.
- The exchange rates between currencies is more of a reflection of the relative economic strength of the countries involved.

# How do Exchange Rates work?

- The Foreign Exchange market is a true indicator of the relative values of currencies.
- The value and popularity of a currency will often be governed by events occurring within a country. The events may be prevailing interest rates, economic conditions, politics and social unrest.

# Different Currencies

- The most widely used currency is the US\$ and some countries have adopted this as their legal tender because their previous currency could not maintain value.
- Otherwise the major traded currencies are £Sterling, the Euro, Japanese Yen and now emerging the Chinese Yuan.

# Currency Risk

- This is the term used to describe the effect of movements between exchange rates of currencies.
- This is a particularly important consideration for international trade. A lot of money can be made or lost on the movement of exchange rates, but it is possible to protect against possible losses.

# Example transaction

- A company decides to export machinery to France. The current price is £100 per machine.
- The rate for the Euro is £1 buys €1.47.  
(Source [www.bbc.co.uk](http://www.bbc.co.uk) 01/03/06)
- Therefore, each machine will cost €147.
- If the rate changes to €1.45 then the French company wins. If it changes to €1.50 then the exporter wins.

# Protection

- This simple example shows the effect of exchange rate movements on a small scale.
- If the transaction is in millions, the chance of this loss (The Exchange Risk) may not be acceptable.
- Therefore, both companies may well consider “hedging” the deal. Therefore, they will arrange to buy or sell the required currency for a certain rate at a later date.

# Options

- The companies will either arrange to buy or sell the currency they need at a certain rate on the date that the invoice is due to be paid.
- Alternatively, they may arrange an option to buy or sell the currency. This means that if the currency has “gone their way” they need not exercise the option.