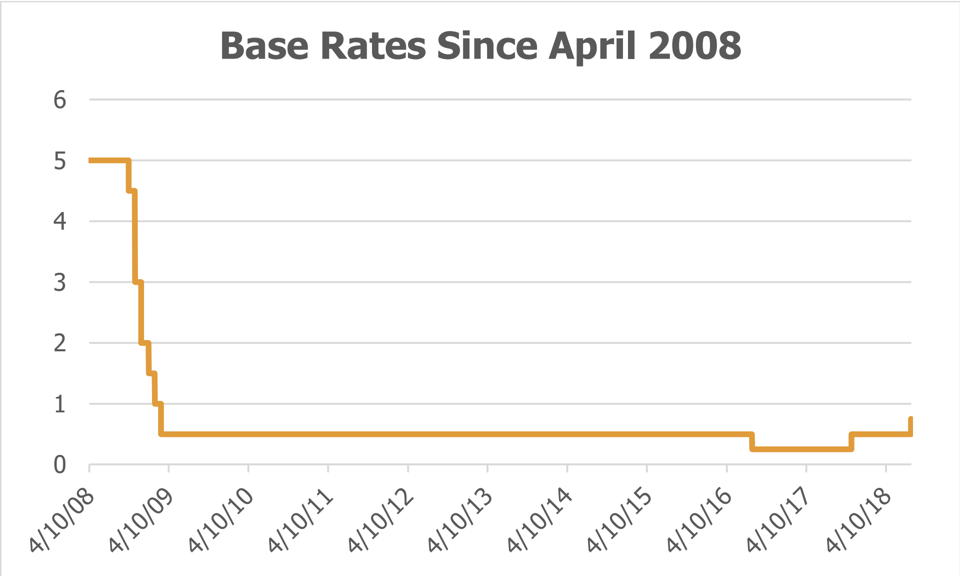
Interest rates creeping up after nine years

The Bank of England increased the base interest rate in August to 0.75% – the second increase in 12 months.



Source: Bank of England August 2018

The Bank's decision to raise the rate to its highest level in nearly nine and a half years was no great surprise to the investment community. Of more interest to the experts were the comments the Bank offered on the long-term trend of base rates relative to inflation. The Bank gave a theoretical estimate of the base rate needed to maintain inflation and economic growth in a fully functioning economy, rather than another forecast of where rates might be in a year's time.

The Bank said an interest rate of 0%–1% above the rate of inflation, with a 'modal rate' of 0.25%, would achieve this equilibrium. In today's economic environment, with an inflation target of 2%, this would mean a base rate of around 2.25%. That implies:

The equilibrium rate will be a long time coming – several 0.25% increases would be required and the Bank has repeatedly said any changes will be gradual.

Returns on savings accounts will continue to be poor and often below the rate of inflation, even before the impact of taxes are allowed for.

Persistently low interest rates mean that holding too much money on deposit could damage your long-term financial health. Whilst we all need to put aside reserves for the proverbial rainy day, the UK has moved on from an era when base rates were expected to be a useful margin above inflation.

For an assessment of how much your ready cash reserve should be, and the options for investing any excess, please talk to us.