Interest Rates

Interest rates and monetary policy

An **interest rate** is the cost of borrowing money: the percentage of the amount of a loan paid by the borrower to the lender for the use of the lender's money. A country's minimum interest rate (the lowest rate that any lender can charge) is usually set by the central bank, as part of monetary policy, designed to keep inflation low. This can be achieved if demand (for goods and services, and the money with which to buy them) is nearly the same as supply. Demand is how much people consume and businesses invest in factories, machinery, creating new jobs, etc. Supply is the creation of goods and services, using labour – paid work – and capital. When interest rates fall, people borrow more, and spend rather than save, and companies invest more. Consequently, the level of demand rises. When interest rates rise, so that borrowing becomes more expensive, individuals tend to save more and consume less. Companies also invest less, so demand is reduced.

If interest rates are set too low, the demand for goods and services grows faster than the market's ability to supply them. This causes prices to rise so that inflation occurs. If interest rates are set too high, this lowers borrowing and spending. This brings down inflation, but also reduces **output** – the amount of goods produced and services performed, and **employment** – the number of jobs in the country.

BrE: labour; AmE: labor

Different interest rates

The **discount rate** is the rate that the central bank sets to lend short-term funds to commercial banks. When this rate changes, the commercial banks change their own **base rate**, the rate they charge their most reliable customers like large corporations. This is the rate from which they calculate all their other deposit and lending rates for savers and borrowers.

Banks make their profits from the difference, known as a **margin** or **spread**, between the interest rates they charge borrowers and the rates they pay to depositors. The rate that borrowers pay depends on their **creditworthiness**, also known as **credit standing** or **credit rating**. This is the lender's estimation of a borrower's present and future **solvency**: their ability to pay debts. The higher the borrower's solvency, the lower the interest rate they pay. Borrowers can usually get a lower interest rate if the loan is guaranteed by securities or other collateral. For example, **mortgages** for which a house or apartment is collateral are usually cheaper than ordinary bank loans or **overdrafts** – arrangements to borrow by spending more than is in your bank account. Long-term loans such as mortgages often have **floating** or **variable interest rates** that change according to the supply and demand for money.

Leasing or hire purchase (HP) agreements have higher interest rates than bank loans and overdrafts. These are when a consumer makes a series of monthly payments to buy durable goods (e.g. a car, furniture). Until the goods are paid for, the buyer is only hiring or renting them, and they belong to the lender. The interest rate is high as there is little security for the lender: the goods could easily become damaged.

BrE: base rate; AmE: prime rate

Match the words in the box with the definitions below. Look at A and B opposite to help you.

creditworthy	floating rate	invest	labour
spread	output	solvency	interest rate

1 the cost of borrowing money, expressed as a percentage of the loan
2 having sufficient cash available when debts have to be paid
3 paid work that provides goods and services
4 a borrowing rate that isn't fixed
5 safe to lend money to
6 the difference between borrowing and lending rates
7 the quantity of goods and services produced in an economy
8 to spend money in order to produce income or profits

Name the interest rates and loans. Then put them in order, from the lowest rate to the highest. Look at B opposite to help you.

a ....: a loan to buy property (a house, flat, etc.)

b ....: borrowing money to buy something like a car, spreading payment over 36 months

c ....: commercial banks' lending rate for their most secure customers

d ....: occasionally borrowing money by spending more than you have in the bank

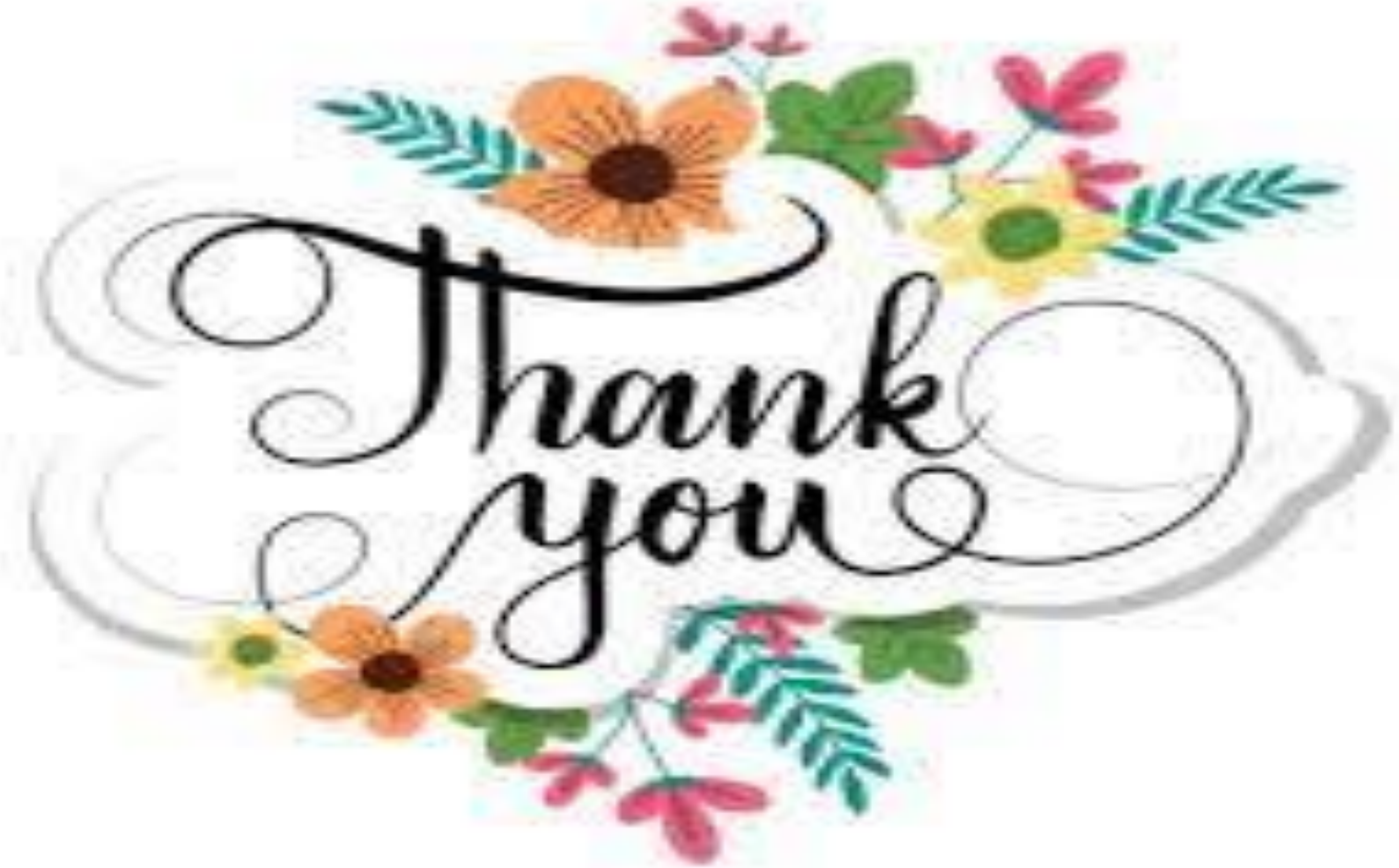
e ....: the rate at which central banks make secured loans to commercial banks

1		2		3		4		5	

lowest highest

Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 All interest rates are set by central banks.
2 When interest rates fall, people tend to spend and borrow more.
3 A borrower who is very solvent will pay a very high interest rate.
4 Loans are usually cheaper if they are guaranteed by some form of security or collateral.
5 If banks make loans to customers with a lower level of solvency, they can increase their margins.
6 One of the causes of changes in interest rates is the supply and demand for money.


Thank you