Forces That Cause Changes in Interest Rates

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An interest rate is the cost of borrowing money. Or, on the other side of the coin, it is the compensation for the service and risk of lending money. In both cases it keeps the economy moving by encouraging people to borrow, to lend, and to spend. But prevailing interest rates are always changing, and different types of loans offer different interest rates. If you are a lender, a borrower, or both, it's important you understand the reasons for these changes and differences. They also have a heavy effect on the rare metals trade, including silver stocks.

Forces Behind Interest Rates

KEY TAKEAWAYS

- An interest rate is the cost of borrowing money.
- Interest provides a certain compensation for bearing risk.
- Interest rate levels are a factor in the supply and demand of credit.
- The interest rate for each different type of loan depends on the credit risk, time, tax considerations, and convertibility of the particular loan.

Lenders and Borrowers

The moneylender takes a risk that the borrower may not pay back the loan. Thus, interest provides a certain compensation for bearing risk. Coupled with the risk of default is the risk of inflation. When you lend money now, the prices of goods and services may go up by the time you are paid back, so your money's original purchasing power would decrease. Thus, interest protects against future rises in inflation. A lender such as a bank uses the interest to process account costs as well.

Borrowers pay interest because they must pay a price for gaining the ability to spend now, instead of having to wait years to save up enough money. For example, a person or family may take out a mortgage for a house for which they cannot presently pay in full, but the loan allows them to become homeowners now instead of far into the future.

Businesses also borrow for future profit. They may borrow now to buy equipment so they can begin earning those revenues today. Banks borrow to increase their activities, whether lending or investing, and pay interest to clients for this service.

Interest can thus be considered a cost for one entity and income for another. It can represent the lost opportunity or opportunity cost of keeping your money as cash under your mattress as opposed to lending it. And if you borrow money, the interest you have to pay could be less than the cost of forgoing the opportunity of having access to the money in the present.

How Interest Rates are Determined

Supply and Demand

Interest rate levels are a factor of the supply and demand of credit: an increase in the demand for money or credit will raise interest rates, while a decrease in the demand for credit will decrease them. Conversely, an increase in the supply of credit will reduce interest rates while a decrease in the supply of credit will increase them.

An increase in the amount of money made available to borrowers increases the supply of credit. For example, when you open a bank account, you are lending money to the bank. Depending on the kind of account you open (a certificate of deposit will render a higher interest rate than a checking account, with which you can access the funds at any time), the bank can use that money for its business and investment activities. In other words, the bank can lend out that money to other customers. The more banks can lend, the more credit is available to the economy. And as the supply of credit increases, the price of borrowing (interest) decreases.

Credit available to the economy decreases as lenders decide to defer the repayment of their loans. For instance, when you choose to postpone paying this month's credit card bill until next month or even later, you are not only increasing the amount of interest you will have to pay but also decreasing the amount of credit available in the market. This, in turn, will increase the interest rates in the economy.

Inflation

Inflation will also affect interest rate levels. The higher the inflation rate, the more interest rates are likely to rise. This occurs because lenders will demand higher interest rates as compensation for the decrease in purchasing power of the money they are paid in the future.

Government

The government has a say in how interest rates are affected. The U.S. Federal Reserve (the Fed) often makes announcements about how monetary policy will affect interest rates.

The federal funds rate, or the rate that institutions charge each other for extremely short-term loans, affects the interest rate that banks set on the money they lend. That rate then eventually trickles down into other short-term lending rates. The Fed influences these rates with "open market transactions," which is the buying or selling of previously issued U.S. securities. When the government buys more securities, banks are injected with more money than they can use for lending, and the interest rates decrease. When the government sells securities, money from the banks is drained for the transaction, rendering fewer funds at the banks' disposal for lending, forcing a rise in interest rates.[1]

Interest keeps the economy moving by encouraging people to borrow, to lend—and to spend.

Types of Loans

Of the factors detailed above, supply and demand are, as we implied earlier, the primary forces behind interest rate levels. The interest rate for each different type of loan, however, depends on the credit risk, time, tax considerations (particularly in the U.S.), and convertibility of the particular loan.

Risk refers to the likelihood of the loan being repaid. A greater chance that the loan will not be repaid leads to higher interest rate levels. If, however, the loan is "secured," meaning there is some sort of collateral that the lender will acquire in case the loan is not paid back (i.e., such as a car or a house), the rate of interest will probably be lower. This is because the risk factor is accounted for by the collateral.

For government-issued debt securities, there is, of course, minimal risk because the borrower is the government. For this reason, and because the interest is tax-free, the rate on treasury securities tends to be relatively low.

Time is also a factor of risk. Long-term loans have a greater chance of not being repaid because there is more time for the adversity that leads to default. Also, the face value of a long-term loan, compared to that of a short-term loan, is more vulnerable to the effects of inflation. Therefore, the longer the borrower has to repay the loan, the more interest the lender should receive.

Finally, some loans that can be converted back into money quickly will have little if any loss on the principal loaned out. These loans usually carry relatively lower interest rates.

The Bottom Line

As interest rates are a significant factor of the income you can earn by lending money, of bond pricing and of the amount you will have to pay to borrow money, it is important that you understand how prevailing interest rates change: primarily by the forces of supply and demand, which are also affected by inflation and monetary policy. Of course, when you are deciding whether to invest in a debt security, it is important to understand how its characteristics determine what kind of interest rate you can receive.