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Why Do Interest Rates Change?

Interest rates change over time, reflecting both the demand from borrowers and the supply of funds available to be loaned by providers of capital. Interest rates are the “price of money”. If a borrower wants to spend more than their actual cash on hand, they need to find someone to lend them the necessary funds. A lender compares keeping their money for their own spending or investing in an alternative investment. Both the lender and borrower look at the interest payment on the loaned amount in percentage terms. A $5 interest payment on a $100 loan that is outstanding for one year is called a 5% interest rate (5 divided by 100). A basic understanding of interest rates is important to both corporate and personal finance..The general level of interest rates reflect economic growth, monetary policy and fiscal policy. The interest rate charged to a borrower reflects the risk that the particular borrower might default on the loan. The movement up and down in interest rates impounds many different factors and is very difficult to predict.

Factors To Consider

Supply and Demand for Funds

Interest rates are the price for borrowing money. Interest rates move up and down, reflecting many factors. The most important among these is the supply of funds, available for loans from lenders, and the demand, from borrowers. For example, take the mortgage market. In a period when many people are borrowing money to buy houses, banks and trust companies need to have the funds available to lend. They can get these from their own depositors. The banks pay 6% interest on five year GICs and charge 8% interest on a five-year mortgage. If the demand for borrowing is higher than the funds they have available, they can raise their rates or borrow money from other people by issuing bonds to institutions in the “wholesale market”. The trouble is, this source of funds is more expensive. Therefore, interest rates go up! If the banks and trust companies have lots of money to lend and the housing market is slow, any borrower financing a house will get “special rate discounts” and the lenders will be very competitive, keeping rates low.

This happens in the fixed income markets as a whole. In a booming economy, many firms need to borrow funds to expand their plants, finance inventories, and even acquire other firms. Consumers might be buying cars and houses. These keep the demand for capital at a high level, and interest rates higher than they otherwise might be. Governments also borrow if they spend more money than they raise in taxes to finance their programs through deficit financing. How governments spend their money and finance their endeavors is called fiscal policy. A high level of government expenditure and borrowing makes it hard for companies and individuals to borrow; this is called the “crowding-out” effect.

Monetary Policy

Another major factor in looking at an interest rate change is the monetary policy of governments. If a government loosens monetary policy, this means that it has “printed more money.” Simply put, the Central Bank creates more money by printing it. This makes interest rates lower, because more money is available to lenders and borrowers alike. If the supply of money is lowered, this tightens monetary policy and causes interest rates to rise. Governments alter the money supply to try and manage the economy. The trouble is, no one is quite sure how much money is necessary and how it is actually used once it is available.

Inflation

Another very important factor in answer why interest rates change is a consideration of inflation. Investors want to preserve the “purchasing power” of their money. If inflation is high and risks going higher, investors will need a higher interest rate to consider lending their money for more than the shortest term. After the very high inflation years of the 1970s and early 1980s, lenders had to receive a very high interest rate compared to inflation to lend their money. As inflation dropped, investors then demanded lower rates, as their expectations become lower. Imagine the plight of the long-term bond investor in the high inflation period.

Answering the Question: Why Do Interest Rates Change?

As we have seen, a number of factors contribute to changes in interest rates. For investors, monitoring the interest rates for different markets is important for predicting the future of their investments and the potential flow of general market conditions.