

Quadrant II - Notes

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Module Name: Interest Rate

Module No: 10

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Meaning of Interest

- Interest is the price the borrowers must pay to lenders to obtain the use of money for a period of time.
- It is the amount charged, expressed as a percentage of principal, by a lender to a borrower for the use of assets.
- Interest rates are typically noted on annual basis, known as the annual percentage rate (APR).

The assets borrowed could include cash, consumer goods and large assets such as a vehicle or building

- Interest is essentially a rental, or leasing charge to the borrower, for the use of an asset
- In terms of borrowed money, the interest rate is typically applied to the principal, which is the amount lent.
- The interest rate is the cost of debt for the borrower and the rate of return for the lender.

- Interest rates are applied in numerous situations where lending and borrowing is concerned.
- Individual borrow money to purchase home, fund projects, start business etc.
- The money that is lent has to be repaid either in lump sum at some pre-determined rate or in monthly instalments.
- The money to be repaid is usually more than the borrowed amount since lenders want to be compensated for their loss of use of the money during the period that the funds are loaned out.

Level Of Interest Rate

- As all other prices are determined in different markets, the equilibrium rate of interest is also determined by the forces of supply and demand in the financial markets.
- There are three theories about the determination of the rate of interest.
 - 1) The Classical Theory
 - 2) The Loanable Funds Theory
 - 3) The Keynesian Theory

1)The Classical Theory

- This theory is associated with the names of Ricardo, Hume, Fisher and others.
- It is a static theory, and, according to it, the rate of interest is a real phenomenon in the sense that it is determined by the real factors.
- It is the supply of savings and the demand for investment that determine the equilibrium rate of interest.
- The aggregate saving is the difference between the total national income and the total consumption expenditure.

- The savings may be effected by individuals, households, business and the government.
- Given the current income, there is a natural tendency on the part of economic units to spend that income on current or present consumption.
- That is there is a time preference in favour of present rather than future consumption.
- To the consumer, business and government, money now is not the same thing as money next year; the money now is valued more than the money next year.
- Because of this time preference, if it is necessary or desired that the current consumption should be postponed, there is a sacrifice involved in such a postponement.
- The various economic units can be induced to undergo this sacrifice and save if they are offered a reward for such an action.
- This reward is known as the 'rate of interest'.
- Thus interest rate is a reward for sacrifice or abstinence or waiting involved in the act of supplying savings .
- On the demand side, firms and other economic units demand capital to make profits by producing goods.
- The investment takes place because by investing in processes of production, economic units expect to obtain more consumption in future by sacrificing present consumption.
- The opportunities to produce more effectively by using indirect methods of production determine investment demand.
- The classical view thus regards interest as determined by demand and supply.

2)The Loanable Fund Theory

- It is a dynamic theory and combines real and monetary factors as determinants of the rate of interest.

- The loanable fund theory is an extension of the classical theory of interest rate determination.
 - According to the loanable fund theory , the rate of interest is determined by the demand for and the supply of funds in the economy at that level at which the two are equated.
 - Thus it is a standard demand-supply theory as applied to the market for loanable funds (Credit), treating the rate of interest as the price of such funds.
 - The theory is based on the following assumptions:
 1. That the market for loanable fund is one fully integrated market, characterised by perfect mobility of funds throughout the market.
 2. There is perfect competition in the market, so that each borrower and lender is a 'price-taker' and one and only one pure rate of interest prevails in the market.
 - The theory uses partial-equilibrium approach in which all factors other than the rate of interest that might influence the demand or supply of loanable funds are assumed to be held constant.
 - The loanable fund theory is claimed to be an improvement over the classical savings and investment theory, since, besides the real factors of savings and investment, it also takes into consideration monetary factors of hoarding, dishoarding and increase in money supply in the determination of interest rate.
- 3) The Keynesian Theory
- According to Keynes, interest rate is purely monetary phenomenon.
 - This means that the rate of interest, at least in the short-run, is determined by the monetary factors, i.e., it depends on the actions of the monetary authorities (the Central Bank and the Government), and on the attitude of economic units towards holding money as an alternative to holding bonds.
 - In other words, interest rate is determined by the interaction between the supply of money and demand for it in the economic system.

- The rate of interest is the reward offered to people to induce them to hold securities instead of cash.
- Cash is perfectly liquid and safe in the sense that there is no danger of physical deterioration or capital loss.
- On the other hand securities can and do vary in value and, therefore, there is a risk of incurring capital loss when securities rather than cash are held.
- Interest is the difference between the yield on safe money and the yield on risky securities.