Interest Rates Essay, Research Paper

Interest Rates

Interest is the charge the lenders set for the borrowing of their money. Interest is done in a percentage like five percent or ten percent. So the lender collects their original money along with extra money based on the percentage rate. Business, governments, and consumers borrow money and lend money.

History

Before the 1500 s most didn t charge for interest because they believed that charging interest was wrong. The Israelites considered lend money without interest a duty that the rich owed to the poor. Also during the Middle Ages, the church made it a sin to charge interest. People were caught charging interest were whipped.

But in 1545 King Henry of England changed the laws to let interest be used. By the 1700 charging interest was considered ok.

Types of Interest

The types of interest are simple, compound and discount.

Simple interest is charged only on the amount borrowed. For example if someone borrows one hundred dollars for a year at ten percent interest then that person will have paid ten dollars.

Compound interest is charged by the amount borrowed and the accumulated interest. If you borrow one thousand dollars at ten- percent interest you will be charged one hundred dollars the first year and one hundred and ten dollars the second year. (1000 x 10% = 100 + 1100 x 10% = 110). Interest may also be compounded at daily monthly, quarterly and semi quarterly.

Discount interest is charged by subtracting from the principal before the borrower receives the money. If someone borrows one thousand dollars at 10% discount rate they would receive nine hundred dollars. Also the borrower would have to repay all one thousand dollars. And would pay one hundred dollars interest.

How interest is calculated

In the United States savings establishments use interest that is compounded daily. The two ways of doing interest is day of depose to day of withdrawal and 2. Day of deposit to end of interest period. Day of deposit to day of withdrawal is the most common method. If you deposit 100 into a saving account one week and add 50 to the account each week for two weeks. At the end of the first week you earn seven days interest one hundred dollars.

How Interest Rates vary

There are different loan markets. One for consumer loans, home mortgages, corporate bonds, state and local government bonds and foreign loans, and they also have their own interest rates that rise and fall. The different interest rates differ by supply and demand. Interest rate rise if 1. The demand for loans increases. 2. The amount of money available for loans decreases.

Interest rates fall if 1. The demand for loans decreases or 2. The amount of money available for loans increases.

Supply and demand is affected by 1.Government policy 2. Inflation 3. Economic activity 4. The length of a loan and 5. The degree of a risk.

Government policy. Government increases or decreases the amount of money available for loans, which in turn have an affect on interest rates. It does this through the nations central bank. The central bank requires all United States banks to setting aside a certain amount of their deposits on reserve. One way the fed controls the amount of money available for loans is by increasing or decreasing the reserve requirement. Federal Reserve System central banking system of the United States popularly called the Fed. A central bank serves as the banker to both the banking community and the government; it also issues the national currency, conducts monetary policy, and plays a major role in the supervision and regulation of banks and bank holding companies. In the U.S. these functions are the responsibilities of key officials of the Federal Reserve System: the Board of Governors, located in Washington, D.C., and the top officers of the 12 district Federal Reserve banks, located throughout the nation. The Fed. s actions, described below, generally have a significant effect on U.S. interest rates and, subsequently, on stock, bond, and other financial markets.

It can follow loose money policy. It is when the government requires banks to keep a lower percentage of money on reserve. This increases the amount of money available for loans and contributes to lower interest rates. The fed uses a tight money policy when it increases the banks reserve. This decreases the money available for loans and makes higher interest rates.

Inflation. In recent years, the problem of inflation has been the issue for interest theory. In the United States, the individual states are responsible for setting a legal rate at which debts may be assessed if they have come due and remain unpaid, and for setting the maximum rate allowed in a contract. In 1981, when rates soared to many legislatures increased or abolished such maximum rates in order to attract lenders. In Great Britain legal interest rates are not fixed by the government, but courts can determine whether a given rate is injurious. When there is inflation an amount of money buys less then what it did before. Examples of inflation and deflation have occurred throughout history, but detailed records are not available to measure trends before the Middle Ages. Economic historians have identified the 16th to early 17th centuries in Europe as a period of long-term inflation, although the average annual rate of 1 to 2 percent was modest by modern standards. Major changes occurred during the American Revolution, when prices in the U.S. rose an average of 8.5 percent per month, and during the French Revolution, when prices in France rose at a rate of 10 percent per month. These relatively brief flurries were followed by long periods of alternating international inflations and deflations linked to specific political and economic events

Length of a loan. Money can be borrowed for one day or for years. Banks lend each other money for a few days. Mortgages may be issued for twenty or thirty years. Short-term loans are for a year or less. Intermediate- term loans are for one to five years and long term loans are for over five years.

Types of loans

Finance, branch of economics concerned with providing funds to individuals, businesses, and governments. Finance allows these entities to use credit instead of cash to purchase goods and invest in projects. For example, an individual can borrow money from a bank to buy a home. An industrial firm can raise money through investors to build a new factory. Governments can issue bonds to raise money for projects.

Credit .In commerce and finance, term used to denote transactions involving the transfer of money or other property on promise of repayment, usually at a fixed future date. The transferor becomes a creditor, and the transferee, a debtor; hence credit and debt are simply terms describing the same operation viewed from opposite standpoints. Interest rates for short-term loans are lower than rates for long-term loans.

Mortgage. Legal instruments those pledges a house or other real estate as security for repayment of a loan. By providing a guarantee that the loan will be paid back, a mortgage enables a person to buy property without having the funds to pay for it outright. If the borrower fails to repay the loan, the lender may foreclose on the property that is, force the sale of the house to recover the amount of the loan.

The mortgage lending process has two instruments, a note and a mortgage. The note specifies the financial terms of a loan agreement. The mortgage contains a legal description of the property and a statement that pledges the property as security for the loan. However, the word mortgage commonly refers to both parts of the loan agreement as a whole.

Degree of risk. Interest can be influenced by credit worthiness of the borrower. That is the probability that the borrower will repay back the loan.

Regulation of Interest Rates

In the federal and state governments regulate borrowing and lending. The consumer Credit Protection Act of 1968, requires lenders to show borrowers the entire loan contract, including the annual interest rates. In this way consumers can calculate the total cost of a loan and compare the cost charged by various lenders.

From 1980 to 1986 the federal Depository Deregulation Committee wrote regulations to remove controls on maximum interest rates that banking and saving institutions could play depositors. The committee disbanded in March 1986 and federally put limits on the interest rates of most consumers bank accounts were eliminated. Since then most interest rates have been based on market forces. The federal government continues to ban the paying of interest on regular commercial checking accounts. Anticipating deregulation, banks began experimenting in the mid- 1980 s with accounts that offered high interest yields in savings account format.