

HOW DO INTEREST RATES WORK?



How Do Interest Rates Work?

– By Prof. *Simply Simple*™



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An interest rate is the cost of borrowing money.

A borrower pays interest for the ability to spend money now, rather than wait until he has saved the same amount.



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For example, if you borrow Rs 100 at an annual interest rate of five percent, at the end of the year you'll owe Rs 105.

The interest a lender receives is his compensation for taking a risk.

How?



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With every loan, there is a risk that the borrower will not be able to pay it back.

The higher the risk that the borrower will default (fail to repay the loan), higher is the interest rate.

That's why maintaining a good credit score will help lower the interest rates offered to you by lenders.



HOW DO INTEREST RATES WORK?

Interest rates work both ways.

Banks, governments and other large financial institutions need cash and they are willing to pay for it.

If you put money into a savings account at a bank, the bank will pay you interest for the temporary use of that money.



HOW DO INTEREST RATES WORK?

Governments sell bonds and other securities for the same reason.

In this case, you are the lender to the government and the interest rate is your compensation for temporarily giving up the ability of spending your cash.

Government-issued bonds pay relatively low interest rates as the risk of default is close to zero.



HOW DO INTEREST RATES WORK?

Interest rates for unsecured credit will always be higher than secured credit.

Secured credit is backed by collateral. A home loan is a classic example of secured credit, because if the borrower defaults on the loan, the bank can always take the house.

Credit cards are unsecured credit because there is no collateral backing the loan, only the cardholder's credit score.



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Long-term loans also carry higher interest rates than short-term loans, because the more time a borrower has to pay back a loan, the more time there is for things to possibly go bad financially, causing the borrower to default.



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Another factor that makes long-term loans less attractive to lenders is inflation.

In a healthy economy, inflation almost always rises, meaning the same rupee amount today is worth less in a few years from now.

Lenders know that the longer it takes the borrower to pay back a loan, the less that money is going to be worth.



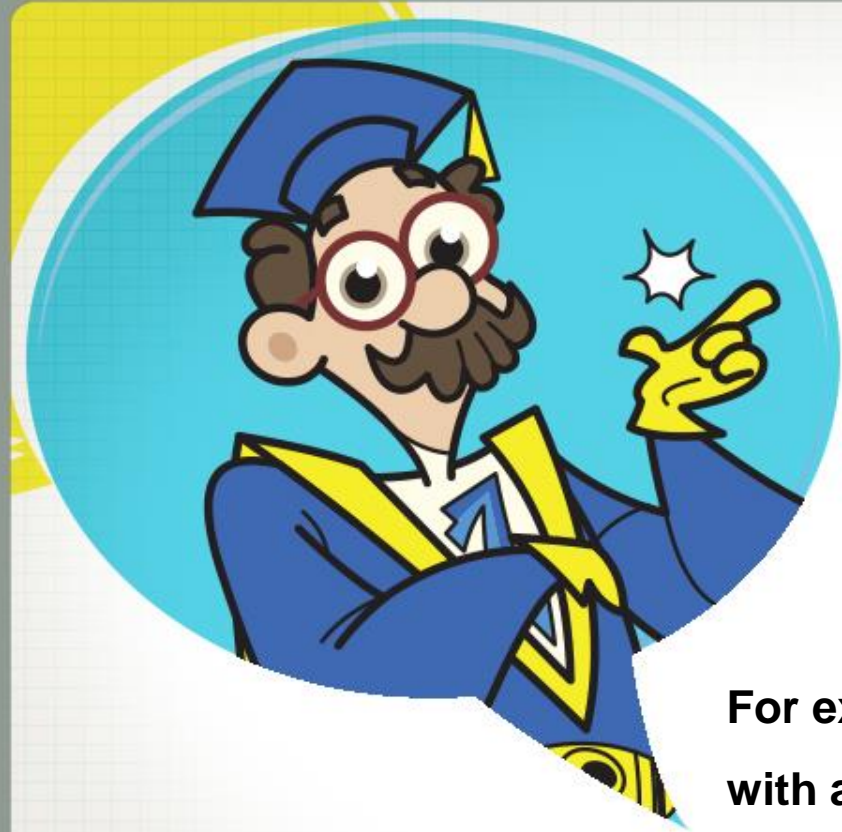
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That's why interest rates are actually calculated as two different values: the nominal rate and the real rate.

- ❑ The nominal rate is the interest rate set by the lending institution.**
- ❑ The real rate is the nominal rate minus the rate of inflation.**



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For example, if you take out a home loan with a nominal interest rate of 10 percent, but the annual rate of inflation is four percent, then the bank is only really collecting six percent on the loan.



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So how do interest rates affect the rise and fall of inflation?

Well, lower interest rates put more borrowing power in the hands of consumers. And when consumers spend more, the economy grows, creating inflation.



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If the RBI decides that the economy is growing too fast, then it can raise interest rates, slowing the amount of cash entering the economy.



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Hope you have now got an understanding of how interest rates work at a conceptual level.



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