



# What Are Interest Rates?

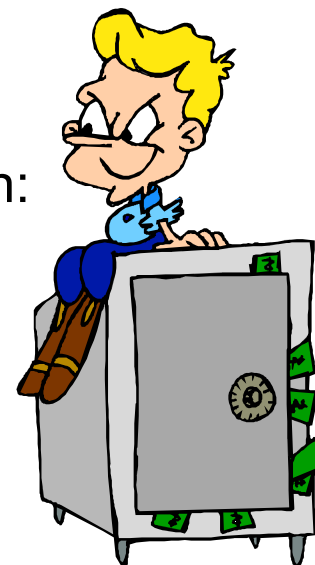
- The rate of interest is effectively “**the price of money**”

- How can money have a price?

  - To work this out, ask yourself the following question:

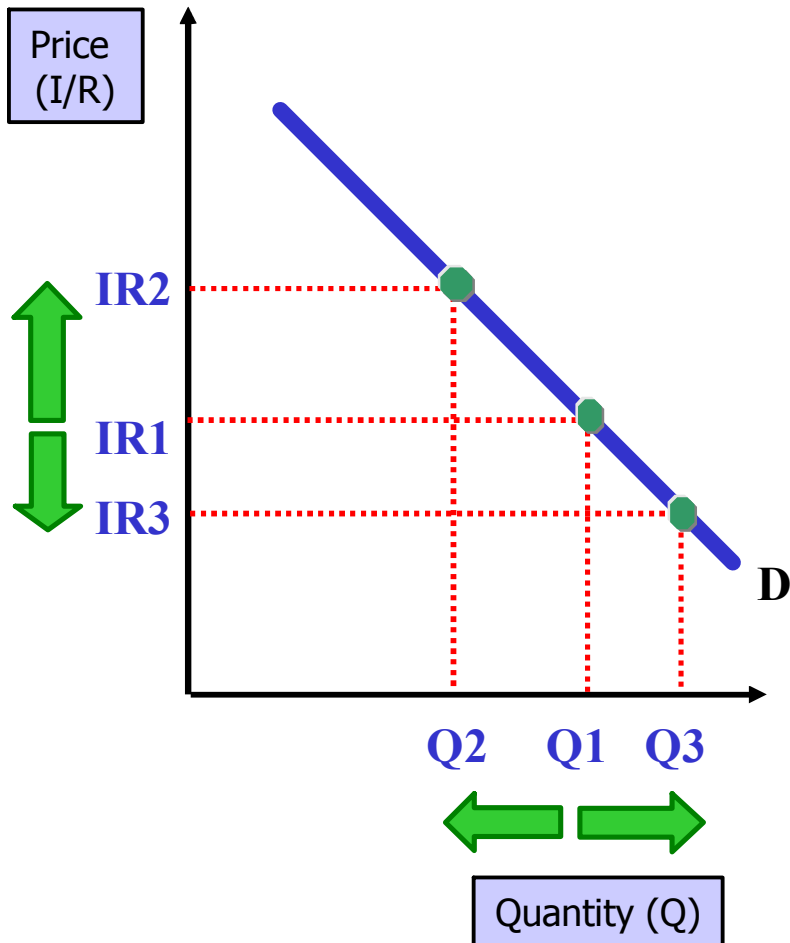
*“If a friend wants to borrow £100 for 1 year, how much would you want back from them at the end of the year?”*

- This means that money can be treated like any other commodity, and so will have a traditional demand curve





# The Demand Curve For Money



- An increase in the  $i/r$  ( $IR1 \rightarrow IR2$ ) causes a decrease in the demand for money ( $Q1 \rightarrow Q2$ ) because:
  - people who have money will hold less. i.e. they will put it in the bank, to earn interest
  - people who borrow money will want to borrow less, because it costs them more
- Explain why a decrease in  $i/r$  will increase the demand for money

# The Economic Effect of Interest Rates



**“An increase in interest rates reduces general spending in the economy, so that general demand (called aggregate demand) falls.”**



- This means that the interest rate is a very powerful economic instrument, and those that have control of it can effectively control the economy



# Who Controls Interest Rates?

- Traditionally the Government has controlled the rate of interest, which is actually set by the Bank of England.
- In 1997 however, the Labour Government set up an independent **Monetary Policy Committee (MPC)** at the Bank of England, and it is this group who now makes decisions about the rate of interest every month “independently” of the government



THE BANK OF ENGLAND

# The Effects of Interest Rates on Businesses



- If interest rates **increase** then a businesses may:



- Reduce or cancel planned investment
  - i.e. the purchase of new machinery
- Reduce borrowing, which may mean cutting costs
  - i.e. labour
- Reduce production
  - since they expect to sell less if consumers have less money

# The Effects of Interest Rates on Consumers



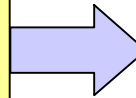
- The effect on consumers will vary, according to whether they are *net borrowers* or *net savers*
- Since most people are borrowers in the UK the overall effect will be that:
  - Consumers will have **less income** available to spend in the shops.
  - Consumers will **reduce spending**, particularly on luxury items.
  - Consumers may try to **save more money**, in order to obtain the higher interest rates being offered by the banks.



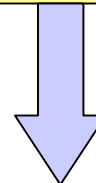
# The Effects of Interest Rates on The Stock Market



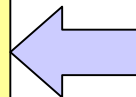
Bank of England  
Puts Interest  
Rates up



Investors will  
sell shares to  
put their money  
in banks



Paper value of a  
business falls,  
making it  
vulnerable



Due to  
increased  
supply, share  
prices will fall

