EW Customized Tutor

English, Economics, Politics, and Philosophy

Unit 2 Topics in Business
Lesson 2.3: Interest Rate

Pertinent Topics:

- Interest Rate
- Determination of Interest Rate

Success Criteria:

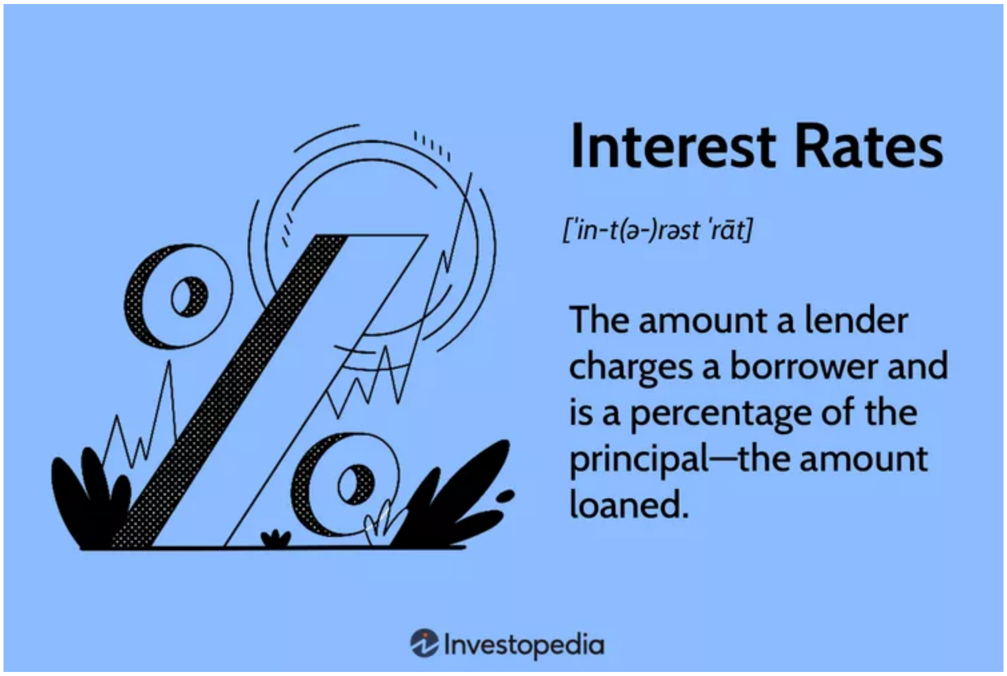
- I will be able to understand the relationship between interest rate, money, and wealth
- I will learn how the interest rate is determined

MINDS ON

Suppose Bob's friend Nathen lends him 100 dollars. Bob promises Nathen that he will pay back these 100 dollars after a year. If Nathen deposits these 100 dollars in his bank, the bank will give him 102 dollars in return in a year. How much of a repayment do you think Bob should pay Nathen after a year?

I. Interest Rate

Interest is essentially a charge to the borrower for the use of an asset. Assets borrowed can include cash, consumer goods, vehicles, and property. Because of this, an interest rate can be thought of as the "cost of money"—higher interest rates make borrowing the same amount of money more expensive.



Interest rates apply to most **lending or borrowing** transactions. Individuals borrow money to purchase homes, fund projects, launch or fund businesses, or pay for college tuition. Businesses take out loans to fund capital projects and expand their operations by purchasing fixed and long-term assets such as land, buildings, and machinery. Borrowed money is repaid either in a lump sum by a pre-determined date or in periodic installments.

II. But How Are Interest Rates Determined?

The interest rate charged by banks is determined by a number of factors, such as the state of the economy. A country's central bank (e.g., the Federal Reserve in the U.S.) sets the interest rate.

When the central bank sets interest rates at a high level, the cost of debt rises. When the cost of debt is high, it discourages people from borrowing and slows consumer demand. Interest rates tend to rise with inflation.

Essentially, interest rate is the opportunity cost of having money (as in cash). Recall the spectrum we saw last week, the more liquidity an asset has the less profitable it becomes. This is essentially attributable to interest rate!!

Question: Do you think ‘trust’ also plays a part in the borrower/lender relationship? For example, if Bob and Nathen are really close friend, will they charge each other interest payment? Why? Now, instead of 100 dollars, if it is 1000000 dollars? Should Nathen charge Bob interest rate? Because he could have otherwise, depositing money in the bank, and received 20000 dollars in a year (2%).