NICO Asset Managers

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INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

15 February 2019

Topic 300: Interest rates movements

Last week, we started looking at interest rates and their effects on investments. We looked at some of the primary policy the Central bank uses to regulate commercial interest rates. These are the Discount rate, the Liquidity Reserve Requirement (LRR) and Open Market Operations (OMO). This week we will continue looking at factors that affect interest rate movements.

Policy rate

The policy rate is the benchmark interest rate set by regulators that determines the levels of the interest rates in the economy. The regulators in this case are the Central Bank and when they reduce the Policy rate, they are aiming at reducing commercial interest rates in the economy. On the other hand, the Central Bank increases the Policy rate when it wants to increase interest rates in the economy.

The Central Bank will also adjust the Policy rate due to the prevailing macroeconomic conditions in an economy. These include inflation rates, business cycles, exchange rate movements, fiscal deficit and government borrowing appetite.

Inflation rate

Increase in inflation rate implies an average increase in general prices of goods and services in an economy. As a result, interest rates as the cost of borrowing also increase. The Central Bank increases the policy rate during times of high inflation rates. On the other hand, low inflation rates will lead to decrease in interest rates.

Business cycles

The business cycle is the rise and fall of economic growth that occurs over time. When the economy is doing well, the investors have the confidence to source funds from the financial institutions like banks and spend. As a result, there is an increase in the demand for funds which leads to an increase in interest rates. On the other hand, when the economy is not doing well, the investors do not have the confidence to spend and hence the demand for funds decreases. This will then reduce the interest rates in the economy.

Fiscal deficit and government borrowing

The government policies and their impact on the fiscal deficit is another factor that influences the interest rates. A fiscal deficit will result when the government's expenditure is more than the revenue it generates. Therefore, the government will borrow money from the market to fund the shortfalls. The government can decide to borrow domestically though the sale of their securities like Treasury bills. Individuals or firms will lend to the government with the government promising a future payment. There will be decrease in money supply leading to an increase in interest rates.

Impact of interest rate movements

Therefore, low interest rates will result in increase in money supply, increase the demand for loans, increase investments and decrease in savings and vice versa. Low interest rates mean low cost of borrowing and this increases the demand for the funds leading to increased money supply. There will be an increase in spending and investments which will increase economic activity. Low interest rates however will lead to low savings as the savers will get lower real returns.

On the other hand, increase in interest rate increases cost of borrowing as the lenders seek a positive real return from their funds. This will decrease the demand for funds and money supply which will reduce investments and spending. On the other hand, the high interest rates will also increase savings as returns are high.

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