111 Interest rates

Interest and interest rates

If a business or an individual borrows money, they usually have to pay **interest** on the loan. Equally, if they put their savings into a bank or building society, they expect to receive interest.

The INTEREST RATE is the price of borrowing or saving money. For example, if a small business borrows £10,000 from a bank for one year, and the interest rate is 7 per cent, it has to pay £700 in interest. Equally, if a business has £1 million in the bank for a year which it uses as working capital, and the rate of interest the bank offers is 3 per cent, it will earn £30,000 in interest.

Different interest rates

A business might be able to borrow money on overdraft at 6 per cent. If it took out a five year loan, the interest rate might be 7 per cent. A consumer buying a house might be offered a mortgage rate of 8 per cent. The interest rate on a credit card might be 15 per cent.

These are just four of the thousands of interest rates in an economy. Each interest rate is set within a market for money. In each market, there is a **demand** for money. This comes from those who want to borrow money. There is also a **supply** of money from those who want to lend money. The forces of demand and supply will fix the price of money in that market, which is the interest rate.

Many money markets are influenced by the rate of interest set by the central bank of a country. In the UK, the central bank is the Bank of England. It has the power to fix the rate of interest charged and offered by the major banks in the UK on short-term loans and savings. Banks such as Barclays or HSBC will change their BASE RATE when the Bank of England declares a change in interest rates. The base rate of a bank is the rate around which all its other interest rates are structured. For short- term savings with the bank, it will offer interest rates below the base rate. For borrowing, it charges above the base rate. The profit it makes out of borrowing and lending has to come from the difference between the lower rate of interest it gives to savers and the higher rate of interest it charges to borrowers.

Base rates are linked to other rates of interest in the economy. When base rates fall, so do long-term rates of interest. The rate of interest on other types of borrowing, such as borrowing through a credit card, also tends to fall. But there is no direct link between these other interest rates and the base rates set by the Bank of England. So short-term interest rates can change and long-term interest rates can remain unaffected. Sometimes, long-term interest rates can be rising when short-term interest rates are falling. It depends on market conditions.

Effect on business overheads

Changes in interest rates are likely to affect the overheads of a business. Interest charges are part of overhead costs. If interest rates rise, businesses are likely to have to pay higher interest payments on their borrowing. For example, a business might borrow £10,000 on overdraft. The annual payments on this would rise from £600 to £700 if the rate of interest rose from 6 to 7 per cent a year.

Not all borrowing is at variable rates of interest. Variable rates mean that banks or other lenders are free to change the rate of interest on any money borrowed. Many loans to businesses are at fixed rates of interest. This is where the bank cannot change the rate of interest over the agreed term (the time over which the loan will be paid off) of the loan. A rise in interest rates in the economy won't affect the overheads of a business with only fixed term loans. But, if a business wanted to take out new loans, it would have to pay the higher rates of interest the bank or other lender was now charging. So overhead costs would rise.

Question 1.

Dalton's is an industrial manufacturer of canning products. It currently has an overdraft of £1.2 million and loans of £4.3 million. Of these loans:

- £1.3 million are variable rate loans, with interest at 2 per cent above base rate;
- £1 million is at a fixed rate of 8 per cent;
- the remaining £2 million is at a fixed rate of 9 per cent.

(a) **Explain why interest on borrowings is an overhead cost for Dalton's.**

(b) **Base rates in the economy fall from 6 per cent to 5 per cent. As a result the overdraft rates for Dalton's falls from 7 per cent to 6 per cent. Calculating the change in interest payments, explain how this will affect the company's overhead costs.**

Question 2.

Bill Lockington was devastated when his business went up in flames. He made a range of tyres, manufactured from existing worn out tyres. His 'retreads' had proved popular with customers because of their high quality and low prices compared with brand new tyres. Due to the high cost of insurance, he was uninsured at the time of the accident and it looked as though ten years' hard work had come to an abrupt end.

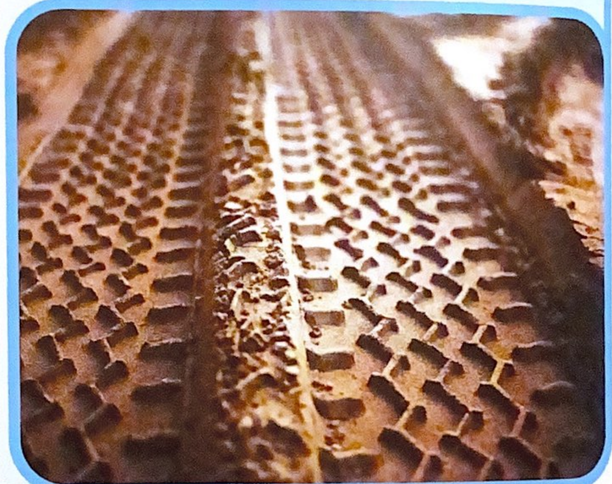
However, having got over the psychological shock of seeing £250,000 worth of equipment and stock destroyed overnight, he decided that it was possible to rebuild the business. Two important things had not disappeared. First, he still had a list of customers who wanted to buy his tyres. Second, he had the knowledge and a skilled workforce to produce quality retreads. Low interest rates were vital to success too. He could not have afforded to borrow the money to restart the business if he could not have borrowed at 7 per cent from his bank. The retread business was also highly dependent on buoyant consumer confidence. Low interest rates encouraged customers to buy vehicles and motorcycles and so create the demand for retreads in the longer term.

Even so, he had to make economies. Before the fire, he had built up stocks worth £100,000 of used tyres. Such large levels of stock were unnecessary for the efficient running of the business. His new business started with just £20,000 worth of stock.

(a) Explain carefully how low interest rates affected Bill Lockington's business.

(b) Suggest why he only bought £20,000 worth of stock to restart the business when previously he had held £100,000 worth of stock.

(c) Discuss whether Bill Lockington could have recovered from the fire if interest rates had been high at the time.



Effect on investment decisions

Changes in the rate of interest affect the amount that businesses invest, for example in new buildings, plant and machinery. There are four main reasons for this.

The cost of loans Investment projects are often financed through loans. A rise in interest rates increases the cost of borrowing money. So projects financed this way will find that the total costs have risen, reducing profitability. This might be enough to persuade some businesses to shelve their investment plans. Total investment in the economy will then fall.

Attractiveness of saving Businesses have the alternative of putting their funds into savings schemes rather than investing in machinery or buildings, for example. A rise in interest rates makes putting money into financial assets relatively more attractive. For example, if interest rates rise from 5 to 8 per cent, a business might decide to shelve an investment project and save the funds instead.

Paying off existing loans A rise in interest rates will increase the cost of existing variable rate borrowing. A business could choose to pay off existing loans rather than increase its investment. This will reduce its costs. It also reduces the risk associated with borrowing.

A fall in demand A rise in interest rates is likely to reduce total spending in the economy, as explained below. This might affect the profitability of many investment projects. For example, a business might forecast that an investment project would be profitable with 20,000 sales a year. But if sales were projected to be only 15,000 a year because of a downturn in demand, then the investment project could be unprofitable and might not go ahead.

Effect on demand

The level of interest rates affects aggregate demand (i.e. total demand) for goods and services in the economy. A rise in interest rates will tend to push down aggregate demand. A fall in interest rates will tend to increase demand.

Businesses are directly affected by changes in demand. When demand falls, their sales go down because less is being bought. If demand rises, businesses receive more orders and more sales.

There are many different ways in which changes in interest rates lead to changes in the sales of businesses.

Domestic consumption Consumers will be hit by a rise in interest rates. The cost of loans will rise. This will deter consumers from buying goods bought on credit, such as cars, furniture and electrical equipment. These goods are known as CONSUMER DURABLES because they are 'used up' over a long period.

In the UK, people who have a mortgage (a loan to buy a house) are also likely to see their monthly repayments rise

because most mortgages are variable rate loans. Existing mortgage holders will then have less to spend on other goods and services. Some potential new home buyers will be put off because they can't afford the repayments, directly hitting the new housing market. If unemployment begins to rise because of less spending, consumer confidence will fall. This will make consumers even less willing to take out loans and spend.

Domestic investment As explained above, businesses are likely to cut back plans for new investment if interest rates rise. Investment goods, like new buildings or machines, are made by businesses. So these businesses will see a fall in their demand.

Stocks Businesses keep stocks of raw materials and finished goods. Stocks cost money to keep, because a fall in stock levels could be used to finance a fall in borrowing and interest payments. So a rise in interest rates will increase the cost of keeping stock. This will encourage businesses to destock, i.e. reduce their stock levels. This will be especially true if the rise in interest rates has hit demand in the economy. With fewer sales, less needs to be produced. So less stock needs to be kept. But cutting stock reduces orders for businesses further up the chain of production. For example, a retailer cutting stocks affects demand from its suppliers. Destocking due to higher interest rates will therefore cause a fall in demand throughout much of industry.

Exports and imports A rise in interest rates tends to lead to a rise in the value of one currency against others. A rise in the pound, for example, will make it harder for UK businesses to export profitably. At the same time, foreign firms will find it easier to gain sales in the UK domestic market because they will be able to reduce their prices. The result is likely to be a fall in exports and a loss of sales to importers in the domestic market. Both will reduce demand and hit UK businesses.

Variable impact on businesses

Changes in interest rates affect different businesses in different ways. Businesses that are most likely to be affected are those which:

- have high levels of borrowing at variable rates of interest;
- sell consumer goods, typically bought on credit;
- are directly linked to the housing market, such as house builders;
- produce investment goods for other businesses;
- depend on exports or are in markets where competition from imports is particularly strong.

A rise in interest rates might have little impact on some of these. For example, a rise in interest rates might not deter consumers from taking out loans because their confidence is high. Or the rise might have little impact on the value of the pound and so not affect exports and imports. The impact depends very much on what else is happening in the economy.

There are also many businesses that are unlikely to see much change in their demand even if other businesses are suffering. For example, consumers tend not to cut back on their spending on food even when times are hard. So supermarkets are often unaffected by changes in interest rates. A hairdressers or a village post office are unlikely to be much affected either.

Strategy and interest rates

Different businesses should have different strategic reactions to changes in interest rates.

- If interest rate changes are relatively small, then there is little need for businesses to change their strategies at all. When interest rates are low, a movement of 1 or 2 per cent in interest rates is unlikely to have much impact.
- Highly indebted businesses are particularly at risk from interest rate rises. Sharp rises in interest rates over a short period of time can push such businesses towards insolvency. They need to reduce their debt burden as quickly as possible. In the short term, this may mean selling assets, if necessary at the expense of future sales and profits. Some businesses may be able to refinance debt. It could be that shopping around banks or other financial institutions will give a lower rate of interest on borrowings. Alternatively, a company may be able to raise share capital and convert some its debt into equity.
- Significant falls in interest rates should stimulate investment by businesses. With the cost of borrowing significantly cheaper, investment projects, which in the past would have been unprofitable, now become profitable. Extra investment might make a business more competitive and allow it to expand sales or market share with the objective of increasing profit and shareholder value. Conversely, a significant rise in interest rates will increase the cost of borrowing, making investment less profitable. So a business is likely to reduce its investment.
- If rises in interest rates are large enough to cause a sharp downturn in the economy, then businesses exposed to markets most affected by the downturn will need to react. A supermarket chain will not see much impact on sales from a downturn and so need take little action. A furniture manufacturer, on the other hand, could see a large drop in sales. It needs to take immediate action to reduce production levels. It should cut stocks and, if necessary, cut the number of workers it employs. The longer the recession, the deeper it will need to cut.

KEYTERMS

Base rate – the rate of interest around which a bank structures its other interest rates. A rise in the base rate will result in a rise in most saving and borrowing rates and vice versa.

Consumer durables – consumer goods such as televisions, furniture and cars which are used over a long period of time. They are often bought on credit.

Interest rate – the price of borrowing or saving money. There are many different interest rates charged in an economy because there are many different markets for borrowed funds.

KNOWLEDGE

1. A business has borrowed £100,000 on overdraft. Bank base rates rise. How is this likely to affect the amount of interest the business pays?
2. What is the difference between variable and fixed rates of interest for a business that has borrowed money?
3. Explain briefly why the investment plans of a business may change if there is a fall in the rate of interest.
4. (a) How might consumers react to a fall in the rate of interest and (b) why might this benefit businesses?
5. Why might businesses destock if interest rates rise?
6. Why might a fall in interest rates lead to a change in export orders?

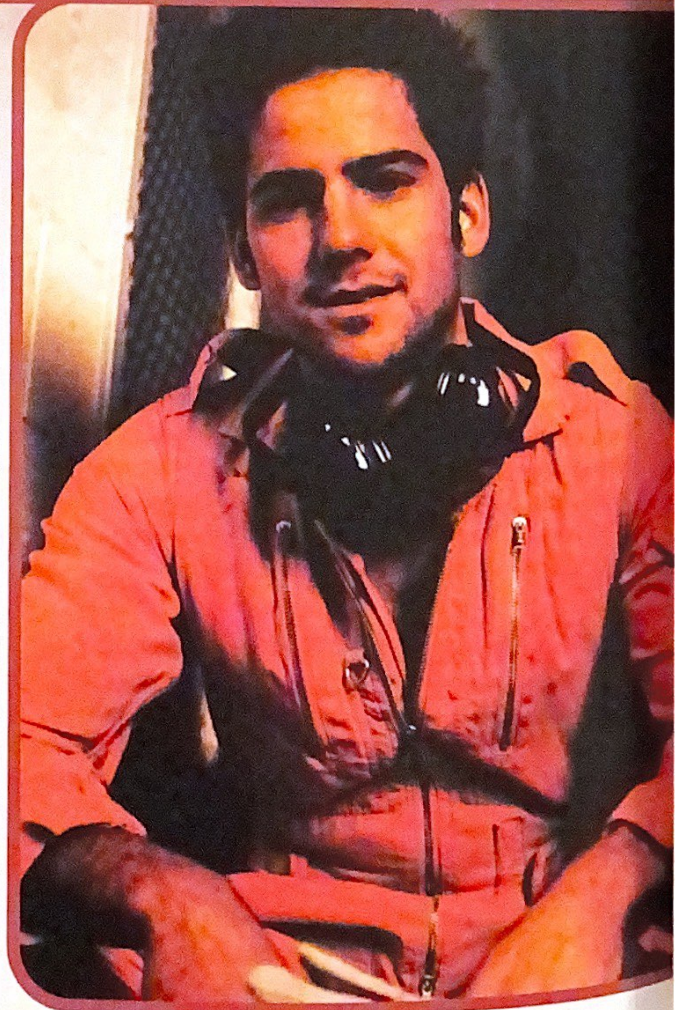
Case Study: Fastenings

In 1991 bank base rates had been at the crippling level of 14-15 per cent for nearly two years. The economy was in the midst of a deep, prolonged recession which had begun in 1989. Al Farrall had run his fastening business for 23 years, but he had never known conditions like this.

He manufactured fastenings mainly for the car and furniture industries. Bolts, castor pegs, nuts and pins were the staple products. Like many businesses, he had expanded in the mid-1980s. Furniture sales were booming in the climate of relatively low interest rates. The housing market was also booming, which encouraged home owners to buy new furniture as they moved house.

At the same time, car production picked up, first for the domestic market and then later for export. But, in 1989, the bottom dropped out of this market. Bank base rates had gone from a low of 7.5 per cent in mid-1987 to 14 per cent by mid-1989. Car production fell back and furniture sales slumped. He not only lost sales volumes, but found himself having to offer ridiculously low priced contracts to win orders.

By early 1991, Al's business was facing closure. He had already been forced to cut the workforce from 20 in 1989 to 12 in 1991, helping to swell the ranks of the UK unemployed which had risen from 1.5 million to 3 million over the period. While his workforce shrank, his borrowing just kept growing. With the benefit of hindsight, he knew that he had made a huge mistake to borrow £150 000 to buy new equipment in 1988. A third of his equipment now lay idle because of lack of orders. His borrowings stood at an unsustainable £200,000 given that the business had made a loss of £25 000 in 1990 and was on track to make a loss of £30,000 in 1991. The business desperately needed a cut in interest rates and a return to growth in the economy.



(a) To what extent were Al Farrall's business problems caused by overborrowing in the late 1980s? (40 marks)

(b) Bank base rates fell from 14 per cent in February 1991 to 6 per cent in February 1993. Discuss whether this change could have helped Al's business to survive. (40 marks)