Why should interest interest you?

What is Interest?

the price paid for the use of money for a period of time (either fixed or variable)

"Interest Rate" can be defined in two ways:

lending rate

the fee charged for lending money

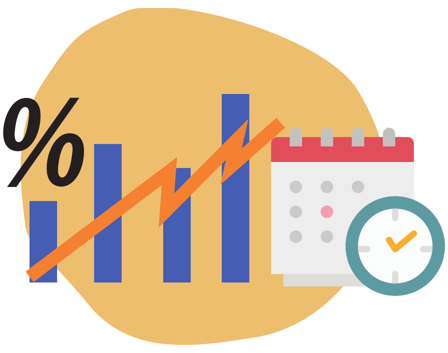
borrowing rate

the cost of borrowing money

Interest rates monitored by the Bangko Sentral ng Pilipinas (BSP)

Lending Rate

the range of interest (low to high) charged by financial institutions for lending money. The lowest rate of interest that a financial institution, such as a bank, charges is called the prime lending rate.



Bank Average Lending Rate

the weighted average interest rate* charged by commercial banks on loans granted during a given period

Savings Deposit Rate

interest rate that a bank pays depositors for the use of their money for the period that the money is on deposit

Time Deposit Rate

the interest rate that a financial institution pays depositors for interest-bearing deposits with fixed-maturity dates as evidenced by a certificate of deposit

Others

- Treasury bill (T-bill) Rate
- Interbank Call Loan Rate
- Philippine Interbank Reference Rate (PHIREF)
- PHP BVAL Reference Rates
- BSP Bills Rate
- Overnight Lending Facility (OLF) Rate
- Overnight Deposit Facility (ODF) Rate
- Term Deposit Facility (TDF) Rate
- Overnight Reverse Repurchase (RRP) Rate

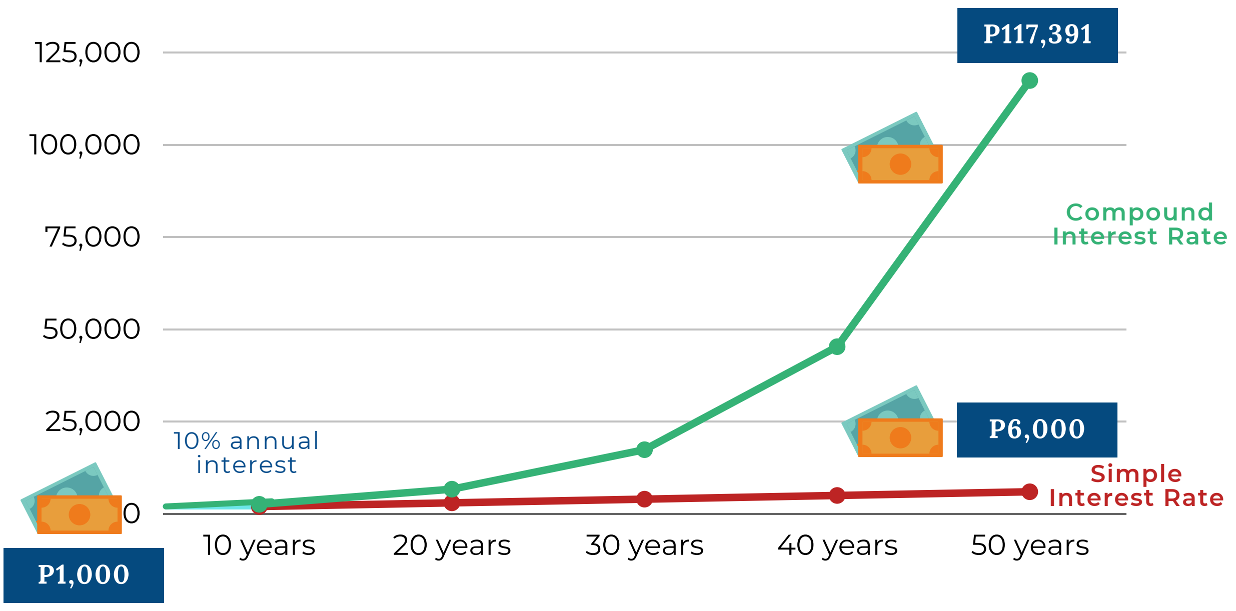
*Weighted average interest rate is the total interest on loans with different rates divided by total loan amount.

Is interest a friend or foe?

It depends on whether you're earning it or paying it.

Simple vs. Compound Interest

While simple interest is interest on the principal amount only, compound interest is interest on interest.



Compound interest is good for savings and investments but it can work against you in paying interest on loans

The difference a decade makes

The power of compound interest over time

Maria

invested money from her first paycheck

25 years old

P5,000

+ P2,500

every year

P102,500

total investment

Juan

waited until he was making enough money to start investing

35 years old

P10,000

+ P5,000

every year

P155,000

total investment

assuming an annual compound rate of 7%

Who earned more by age 65?

The magic ingredient here is TIME. WHEN you start saving outweighs HOW MUCH you save. The more time that an investment has to compound, the greater the potential return will be.

JUAN INVESTED 2X AS MUCH as Maria each year for 30 years, but Maria still ended up with more money!

How are interest rates determined?

Market rates are generally determined by supply and demand in the money market.

Market-oriented Interest Rate Policy

Since 1983, the level of interest rates is **determined by the interaction of the supply and demand** for funds in the money market.

The BSP does not regulate the interest rate charged by banks, lending investors and pawnshops.

The BSP only sets overnight rates, including the RRP rate, also known as the **key policy rate.** It is the interest rate at which the BSP borrows from banks to maintain price stability. (See infographics on "How does interest rates affect consumers?" and "What is BSP's role?")

Special Circumstances

Under the BSP Charter, however, the BSP can impose/regulate interest rates **as warranted under extraordinary economic and social conditions or crises**.

For example, on 24 Sep 2020, the BSP issued **Circular No. 1098** which puts a ceiling on interest or finance charges from credit card transactions. The ceiling aims to ease the financial burden of consumers amid a challenging operating envirobment caused by the **COVID-19 pandemic**.

Why does the BSP allow the market to determine interest rates?

The re-imposition of rate ceilings or limits may lead to distortions in the credit market.

Banks may be discouraged to lend as interest rate ceilings imposed by the BSP may not be enough to cover banks' costs and risks.

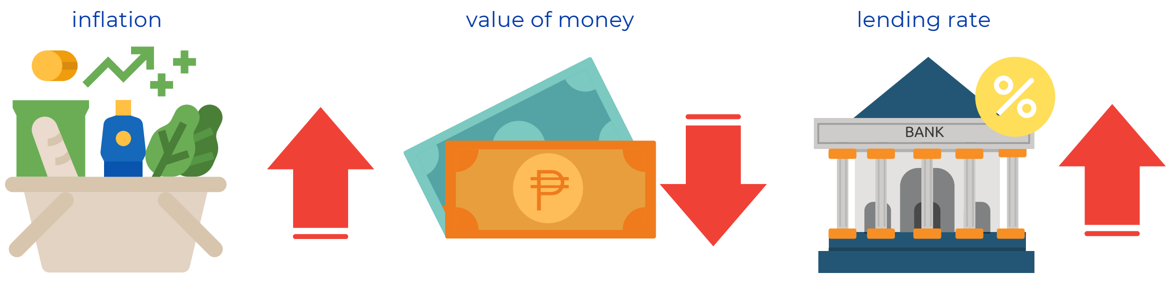
This may lead to limited loan products, stricter requirements and lesser loan approvals.

Demand for rate ceilings may spread to other financial products such as microfinance and consumer loans.

What are the factors that influence the rise and fall of interest rates?

INFLATION RATE

annual percentage increase in the average price of the standard basket of goods and services consumed by a typical Filipino family for a given period



Lenders will demand higher interest rates as compensation for the decrease in purchasing power of the money they are paid in the future.

FISCAL POLICY STANCE

how the government's level of spending and taxation impact aggregate demand and economic growth

When the government spends a lot more than it collects,

there is stronger demand to borrow to finance the gap in the budget.

This exerts upward pressure on domestic interest rates, particularly if the government borrows from a relatively less liquid domestic market.

INTERMEDIATION COST

the cost incurred by financial institutions in extending their services. Included in the intermediation costs are administrative costs and the BSP's reserve requirements.

Interest rates will tend to be high when intermediation cost is high. The cost of doing business varies from bank to bank and this is reflected in the different lending rates charged by the banks.

OTHER FACTORS

the maturity period of the financial instrument

the perception of risks associated with the instrument

non-performing assets (NPAs)

Those with longer-term maturity and with higher probability of incurring loss carry higher interest rates. Moreover, banks with larger holdings of non-performing assets (NPAs) are more cautious in their lending activities. This would tend to induce an increase in interest rates.

How does interest rates affect consumers?

Interest rates can either slow down or boost the economy.

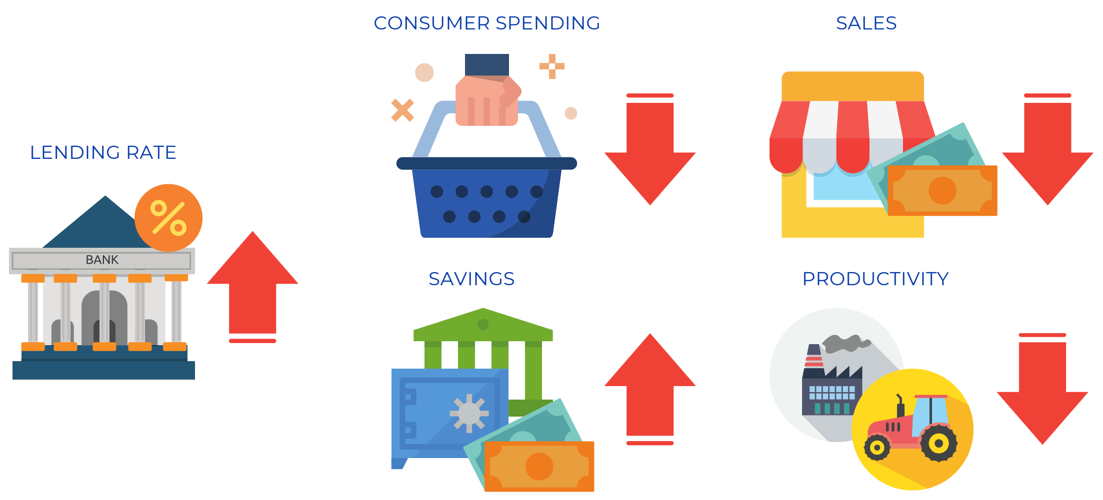
Importance of Interest Rates in the Economy

- influences consumer and business spending
- influences cost of borrowing
- influences return on savings
- indicates potential return on investments
- provides insight into future economic and financial market activity

Changes in interest rates can have both positive and negative effects on markets.

How Interest Rates Affect Spending: The Impact of High Versus Low Interest Rates

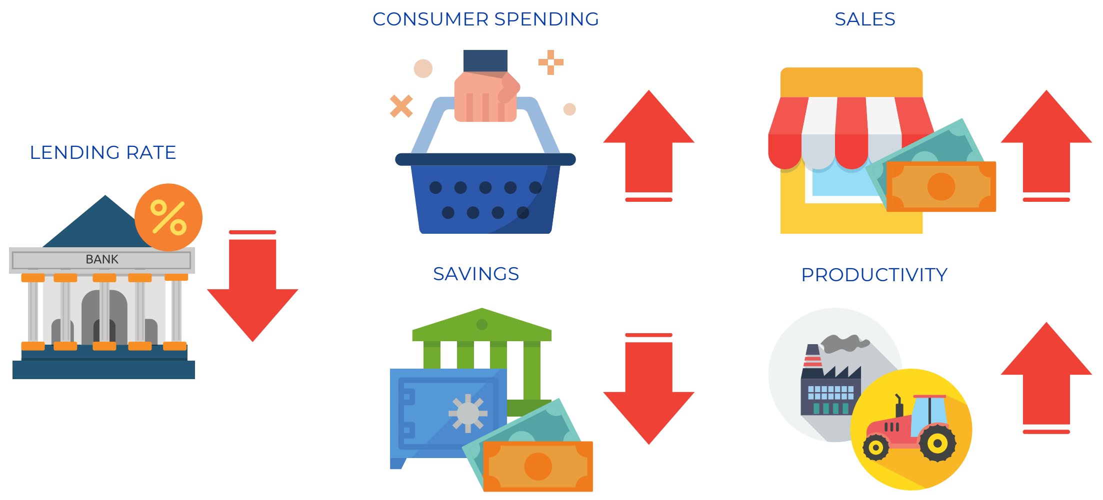
HIGH INTEREST RATES CAN SLOW DOWN THE ECONOMY



When interest rates are high, bank loans cost more, and consumers must cut back on spending. Businesses and farmers, for example, must cut back on spending for new equipment, thus slowing productivity, or reducing the number of employees. However, high interest rates encourage more people to save because they receive more on their savings. Demand falls and companies sell less. When there is less money circulating in the economy, the economy slows down.

A RECESSION occurs when an economy contracts for two consecutive quarters.

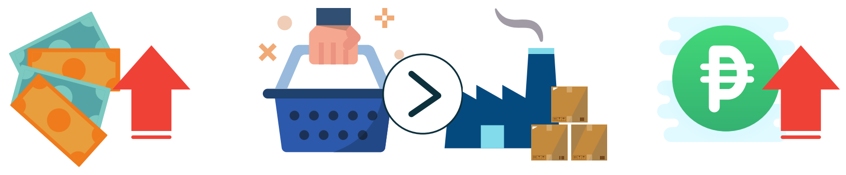
LOW INTEREST RATES CAN BOOST THE ECONOMY



When interest rates fall, people and companies borrow more and save less. Output and productivity increase and boost economic growth.

If low interest rates provide so many benefits, why aren't they kept low all the time?

Having very low interest rates for a long time can cause INFLATION.



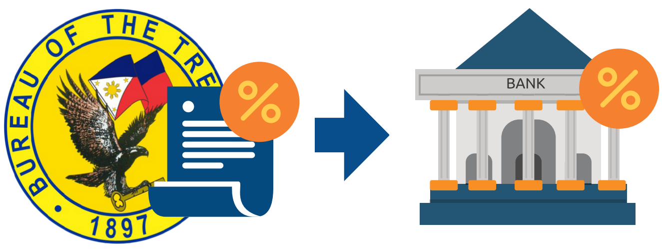
DEMAND OUTSTRIPS SUPPLY AND PRICES RISE WHEN THERE IS TOO MUCH LIQUIDITY

A prolonged period of low interest rates encourages financial institutions to lend more to business and households despite potential risks. This poses threats to financial stability.

What is BSP's role?

The BSP's key policy rate influences market interest rates.

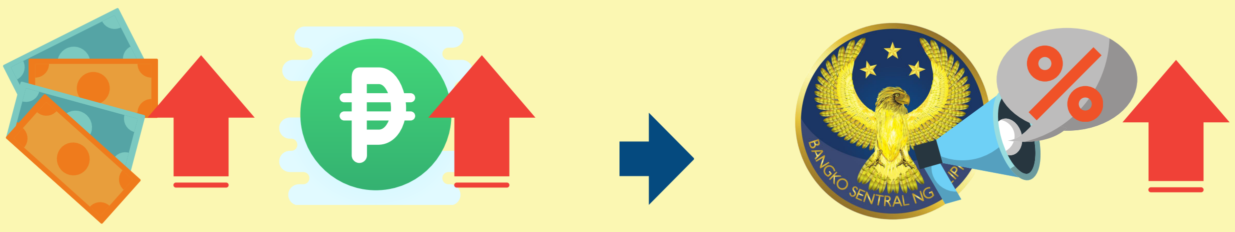
The BSP can either increase or decrease its key policy rate. This gives the market a signal on the general level of interest rates.



In mirroring the movement of the BSP's key policy rate, the benchmark 91-day T-bill rate also sets the direction for other rates, specifically, bank lending rates.

CONDITION

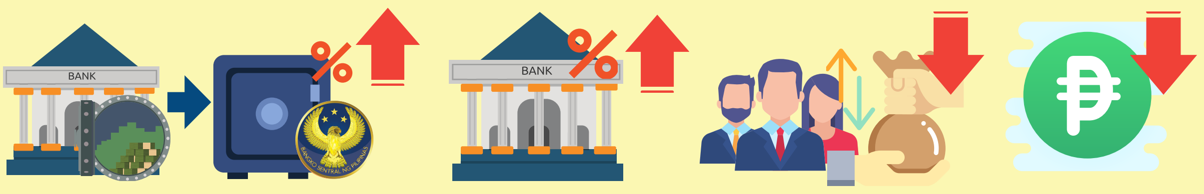
BSP ACTION



Above-target inflation forecast or rising inflationary pressures due to excess domestic liquidity

BSP increases its key policy rate

EFFECTS



Banks are encouraged to deposit in the BSP

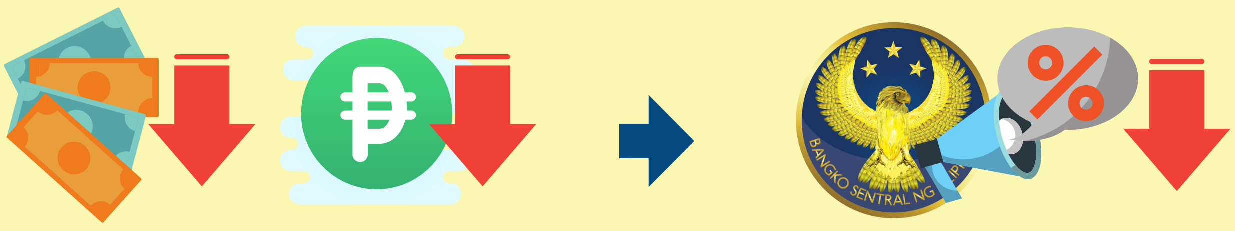
Bank lending rates increase

Less businesses and households borrow

Inflationary pressures ease

CONDITION

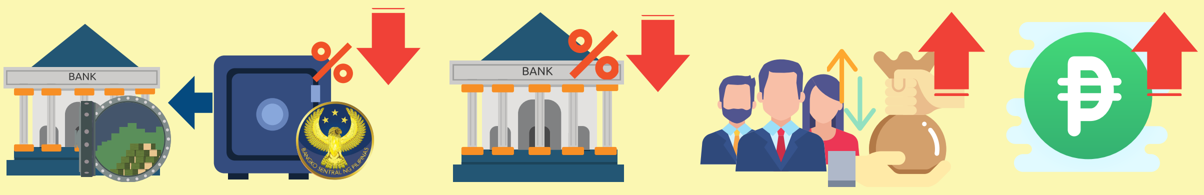
BSP ACTION



Below-target inflation forecast or a need to increase liquidity in the financial system

BSP decreases its key policy rate

EFFECTS



Banks lessen their deposits in the BSP

Bank lending rates decrease

More businesses and households borrow

Economic activity is stimulated

Nominal rate

Real interest rate

Inflation expectations

Real return on funds

The BSP cannot set the real interest rates because it cannot set inflation. However, the central bank's policy action can influence inflation expectations. Thus, by signaling its policy intent through nominal policy rate adjustment, the central bank can affect the real return on funds faced by households and firms.