

# Compounding interest

We've been looking at exponential decay problems, like half life, Newton's Law of Cooling, and sales decline, but now we want to turn from exponential decay to exponential growth, starting with compound interest problems.

## Compound interest

In general, the idea of compound interest is that the interest our money earns, itself earns interest.

For instance, if we deposit \$100 into an account that earns 5 % interest annually, then we'll earn  $\$100 \cdot 5\% = \$5$  in interest the first year.

Then at the beginning of the second year, we'll be starting with \$105, instead of just \$100. Which means that, at 5 % , we'll be earning interest not only on the initial \$100 deposit, but also on the \$5 of interest we earned in the first year. So during the second year, we'll earn  $\$105 \cdot 5\% = \$5.25$ .

And this pattern will continue year after year. We'll have only deposited the initial \$100, but the interest we earn each year will get compounded.

When interest is **compounded**, it means that the interest gets added to the principal that we initially deposited, and therefore will itself also earn interest. Because of this compounding, we'll earn more and more interest each year, which is what we see in the table.



Year	Interest earned	Running balance
1	\$5.00	\$105.00
2	\$5.25	\$110.25
3	\$5.51	\$115.76
4	\$5.79	\$121.55
5	\$6.08	\$127.63
6	\$6.38	\$134.01
7	\$6.70	\$140.71
8	\$7.04	\$147.75
9	\$7.39	\$155.14
10	\$7.76	\$162.90

## Exponential growth

In the table above, we see the exponential growth of the compounding interest. The account is earning more and more interest each year, and the running balance in the account is therefore growing by a larger and larger amount each year.

It's this kind of exponential growth that we model with

$$A = Pe^{rt}$$



where  $P$  is the initial investment (the principal),  $r$  is annual interest rate, and  $A$  is the amount in the account after time  $t$ . Sometimes we'll write this formula as

$$FV = PVe^{rt}$$

where  $A = FV$  is the “future value” in the account, and  $P = PV$  is the “present value” in the account.

Let's work through an example where we use the formula to calculate the amount in the account after a certain period of time.

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### Example

We invest \$2,000 at a rate of 3 % compounded continuously. How much will the investment be worth after 3 years?

From the question, we know that the principle is  $P = \$2,000$ , the interest rate is  $r = 0.03$ , and the time is  $t = 3$ . Substitute these values into the compound interest formula

$$A = Pe^{rt}$$

$$A = 2,000e^{0.03(3)}$$

$$A = 2,000e^{0.09}$$

$$A \approx 2,188.35$$

So after 3 years, at 3 % interest, the investment is worth about \$2,188.35.



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Let's try another example. In this one, we'll earn different interest rates over different periods of time, so we'll need to compute each of those time periods separately.

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### Example

We invest \$6,000 at 2 % for 2 years. After 2 years, the interest rate increases to 3.5 % for the next 2 years. Then, after those first 4 years, the interest rate increases to 5 % . Find the value of the investment after 3 years, and the value after 6 years.

We'll need to handle each interest rate separately. Let's call the first 2 years the "first term," the second 2 years the "second term," and everything after that the "third term."

We'll use subscripts to denote whether the rate belongs to the first term, second term, or third term.

$$r_1 = 0.02$$

$$r_2 = 0.035$$

$$r_3 = 0.05$$

We know  $P_1 = \$6,000$  but we don't know  $P_2$  or  $P_3$ . Let's find those now since we'll need them to answer both parts of this question.  $P_2$  will equal  $A_1$ , the



amount of money we have at the end of the first term (after 2 years). But we can find  $A_1 = P_1 e^{r_1 t}$  where  $t = 2$ .

$$A_1 = P_1 e^{r_1 t}$$

$$A_1 = 6,000 e^{0.02(2)}$$

$$A_1 = 6,244.86$$

$$P_2 = 6,244.86$$

Next we remember that  $P_3$  will equal  $A_2$ , the amount of money we have at the end of the second term (2 years after the end of the first term, 4 years since the beginning of the first term). So  $A_2 = P_2 e^{r_2 t}$  where  $t = 2$ .

$$A_2 = P_2 e^{r_2 t}$$

$$A_2 = 6,244.86 e^{0.035(2)}$$

$$A_2 = 6,697.66$$

$$P_3 = 6,697.66$$

Armed with  $r_1$ ,  $r_2$ , and  $r_3$ , plus  $P_1$ ,  $P_2 = A_1$ , and  $P_3 = A_2$ , we can tackle both parts of this question.

In order to solve for the value of the investment after 3 years, we'll use the data for the second term. But we have to remember that 3 years into the investment is 1 year into the second term, so  $t = 1$ ,  $P_2 = 6,244.86$  and  $r_2 = 0.035$ .

$$A_{3 \text{ years}} = 6,244.86 e^{0.035(1)}$$



$$A_{3 \text{ years}} = 6,467.30$$

The investment would be worth \$6,467.30 after 3 years.

In order to solve for the value of the investment after 6 years, we'll use the data for the third term. But we have to remember that 6 years into the investment is 2 years into the third term so  $t = 2$ ,  $P_3 = 6,697.66$  and  $r_3 = 0.05$ .

$$A_{6 \text{ years}} = 6,697.66e^{0.05(2)}$$

$$A_{6 \text{ years}} = 7,402.06$$

The investment would be worth \$7,402.06 after 6 years.

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