Six factors that influence interest rates in an economy

Reserve Bank of India has cut the repo rate by 25 basis points in the maiden monetary policy review of the calendar year 2019. It indicates interest rates in the economy are on their way down. Besides the repo rate, following are a few factors that influence the interest rates in the economy. Here are they:

1. **Demand for money**
   Typically, in a growing economy, money is in demand. Manufacturing sector companies and industries need to borrow money for their short-term and long-term needs to invest in production activities. Citizens need money as they need to borrow for their homes, buy new cars, and other needs. But when an economy isn't doing that well, companies avoid borrowing if the demand for their products is low.
   A very high inventory is detrimental, so they produce less. In effect, they borrow less, ergo less demand for money. Consumers also spend less as a bad economy could result in job loss. Other things remain the same, higher the demand for money, higher the interest rates.

2. **Supply of money**
   Like any other commodity, if the supply of money increases, other things remain the same: the price of money—interest rates, go down.
   There are situations wherein the investors do not have attractive avenues and they chase the bonds or deposits. If there is no demand for that money at that moment, then the interest rates go down.

   In recessionary times the interest rates tend to go down. A case in point is the sudden dip that took place in bond yields for a short period of time after the announcement of demonetisation.
   As the general public deposited the demonetised currency notes into bank accounts, banks were flooded with money. The banks could not lend all that money so they choose to invest in government securities and that led to a fall in yields on bonds. Please note that the fall in bond yields was temporary.

3. **Fiscal deficit and government borrowing**
   Fiscal deficit is a result of government expenditure exceeding government revenue. To fund this deficit, the government resorts to borrowing. Being the largest borrower in the economy, the quantum of government borrowing influences the demand for money and in turn sways interest rates.
   Higher the fiscal deficit, higher the government borrowing, higher the interest rates. Generally, bond markets respond to higher fiscal deficits by an uptick in bond yields.

4. **Inflation**
   Prices of all goods and commodities are set by taking into account the general price increase in the economy—inflation. Interest rates, which are the price of money, are no exception to this rule.
   Savers need to be compensated by way of higher interest rates for sacrificing their current consumption motives in a high inflationary scenario. Investors will forgo their current consumption and invest in fixed income investments if they get a positive real rate of return.
   The real rate of return is arrived at by deducting the inflation number from the nominal rate of return offered on the bonds and deposits. The ideas to keep the real rate of return positive so that after inflation the saver saves something. That means in a high inflation era, the interest rates tend to stay up and vice versa.

5. **Global interest rates and foreign exchange rate**

   Integration of the Indian economy with the global economy has risen compared to what it was prior to acceptance of globalisation in 1991. That means the interest rates in the economy must be set in line with global trends in interest rates.

   If India wants to attract global capital then the interest rates in India need to go up if the interest rates are going up globally. There are occasions such as the Lehman Crisis in 2008 when the central bankers across the globe choose to cut interest rates to pull the global economy out of recession.

   Attractive interest rates bring in capital and support the foreign exchange rate. Tweaks in the interest rates in the economy can be used by a central bank for influencing the exchange rate. A central bank may choose to up the policy rates (repo rate in India) to indicate higher interest rates in the economy and thereby attract capital from overseas investors.

6. **Central bank**

   The Reserve Bank of India chooses to focus on various objectives while preparing its monetary policy. In a boom phase, the central bank may focus on containing inflation and hence may choose to hike interest rates. That curtails the consumption and investments driven by borrowed money. In a recessionary period, the central bank may want to induce growth by incentivising consumption and investments by reducing the interest rates. The Central bank’s monetary policy objectives thus influence the interest rates.