Interest Rates

Credit and why businesses need it

Some small businesses trade in cash – and nothing else. Customers pay in cash and the expenses and costs of the business are settled in cash. There is no need for credit.

However, most businesses cannot survive simply with the cash they have in the bank. They need to borrow or lend from banks, suppliers and others in order to trade.

So in business, **credit** is about **borrowing** – owing money to others for a period of time.

For example, credit arises when:

- A business makes use of a **bank overdraft facility** – e.g. the bank account goes £50,000 “into the red” or overdrawn
- A business takes out a **bank loan** – e.g. £100,000 loaned over five years
- A business buys goods or services from a supplier and agrees to pay for them in 30 days – this is known as **trade credit**

The amount of credit that a business can raise will depend on several factors such as:

- Whether the business is profitable and is likely to remain so in the future
- The ability of the business to generate a positive cash flow to allow it to repay credit
- The strength of the relationship between the business and its creditors
- The industry or market in which the business operates

You may have heard about the **“credit crunch”** during 2008 and 2009. The credit crunch was about a reduction in the availability of credit for businesses. As lenders struggled to stay in business, they lost confidence in the ability of businesses to repay credit. So many businesses found themselves in financial trouble due to:

- Banks withdrawing or lowering overdraft facilities
- Banks refusing to provide bank loans, or making the repayments and interest charges worse
- Suppliers insisting on earlier payment of invoices
- Customers taking longer to pay their bills

The effects of the credit crunch – notably an increase in failed businesses – show just how important credit is to the business community.

Interest rates

An interest rate is the **cost of borrowing money** or the **return for investing money**.

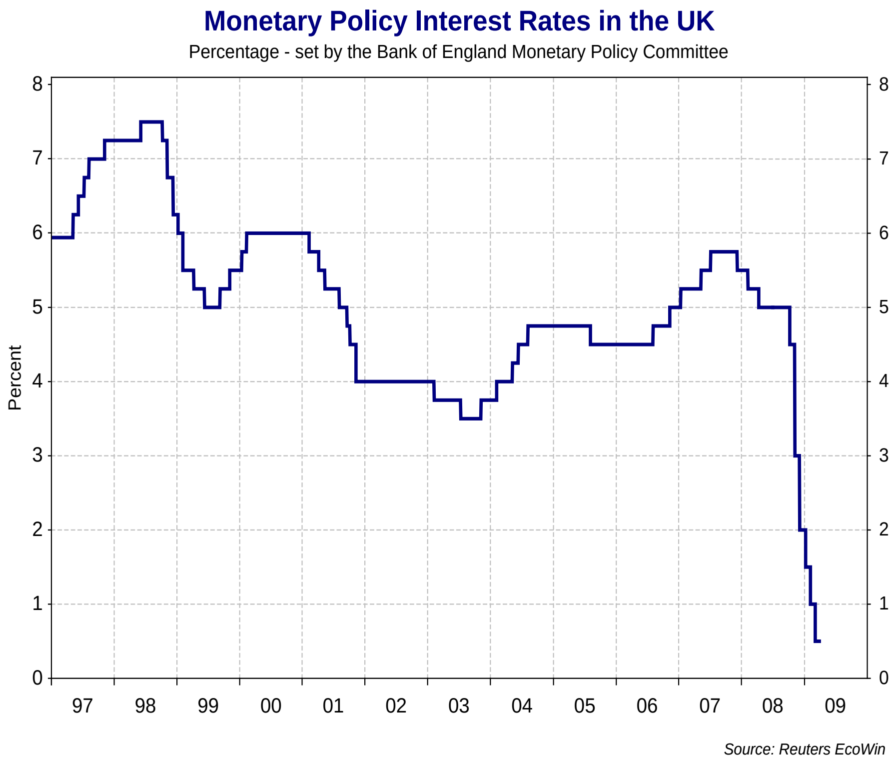
For example, a bank charges interest on amounts loaned out or on the balance of an overdrawn bank account.

A bank will also pay interest to the owner of an account with a positive balance.

Interest rates vary depending on the type and provider of borrowing.

The **base interest rate** in the UK economy is set by the Bank of England. Each month, the Monetary Policy Committee of the Bank of England to decide what the base rate should be.

During the credit crunch, the base interest rate has fallen sharply to as low as 0.5%, as shown in the chart below:



The base interest rate set by the Bank of England affects other interest rates in the economy because it is the rate at which banks can themselves lend from the Bank of England.

In theory, a lower base rate will lead to lower interest rates on borrowings paid by businesses – but not necessarily.

The effect of a change in interest rate will be affected by whether borrowing is at a **variable** or **fixed** rate:

With a variable rate, the interest charged varies in relation to the base rate. So a fall in the base rate to 0.5% in early 2009 should mean that businesses with variable-rate overdrafts pay lower interest.

A fixed interest rate means that the interest cost is calculated at a fixed rate – which doesn't change over the period of the credit, whatever happens to the base rate.

How businesses are affected by changes in interest rates

The effect of a change in interest rates will depend on several factors, such as:

- The amount that a business has borrowed and on what terms
- The cash balances that a business holds
- Whether the business operates in markets that depend on consumer spending

Let’s look at the third factor listed above to examine the implications a little more closely.

Consider the example of households and consumers who like to pay for their goods and services using borrowing such as credit cards or a bank overdraft or loan. Also think about households who have substantial balances outstanding on a mortgage used to finance a house purchase.

An increase in interest rates will mean that the cost of borrowing rises.

In theory, a higher bank base rate will mean that credit card companies such as Visa and MasterCard will also raise the rate they charge borrowers on amounts that are outstanding.

A higher interest rate will also mean an increase in the monthly mortgage payments that are made by home-owners who have mortgages which are charged at a variable rate.

In both cases, the disposable income of consumers and households will fall.

The monthly mortgage payment might rise from say £500 to £550, which means that the household has £50 less disposable income available to spend or save.

If consumers and households think that the rise in interest rates is temporary or short-term, they may simply continue to spend as before. In this case, there will be little effect on demand. However, it might also prompt them to cut back on spending, which would result in lower demand.

Some businesses operate in markets which are very sensitive to changes in interest rates. These markets often involve goods and services where the purchase is financed by debt and where the price paid is relatively significant compared with the customer’s income. For example:

- Housing (mortgages)
- Motor vehicles
- Holidays
- Major purchases of consumer goods – e.g. new kitchen equipment, audio-visual systems