Standard 12 : Role of Interest Rates

Students will understand that:
Interest rates, adjusted for inflation, rise and fall to balance the amount saved with the amount borrowed, which affects the allocation of scarce resources between present and future uses.

Students will be able to use this knowledge to:
Explain situations in which they pay or receive interest, and explain how they would react to changes in interest rates if they were making or receiving interest payments.

Interest rates influence the borrowing and saving of business investors, consumers, and government agencies. Most people are unfamiliar with interest rates until they wish to borrow money for a major purchase such as an automobile, college education, or a house. When they enter the market for credit they encounter an unfamiliar price (the interest rate) offered by an unfamiliar business (a financial institution). It is necessary for students to understand that interest rates are determined by market forces that balance savings and borrowing. For many people, interest rates can represent significant financial costs and significant financial benefits over a lifetime.

It is also important for students to understand the incentive effects of interest rates. Interest payments compensate savers for postponing current consumption; they compensate lenders for the risk that borrowers might default on their loans; and they cover the cost of expected inflation over the term of the loan.

Benchmarks

Grade 12

At the completion of Grade 12, students will know the Grade 4 and Grade 8 benchmarks for this standard, and also that:	At the completion of Grade 12, students will use this knowledge to:
An interest rate is a price of money that is borrowed or saved.	Identify the current rates of interest on different kinds of savings instruments and different kinds of loans.
Like other prices, interest rates are determined by the forces of supply and demand.	Determine the interest rate on 30-year fixed-rate conventional home mortgages over the last 15 years and explain why this rate rose and fell.
The real interest rate is the nominal or current market interest rate minus the expected rate of inflation.	Collect data on the rate of inflation and interest rates for various kinds of loans and savings instruments over the past 15 years. Discuss the relationship between the

	observed inflation rates and expected rates of inflation in any given year. Using this information estimate the real rate of interest in these different years.
Higher real interest rates provide incentives for people to save more and borrow less. Lower real interest rates provide incentives for people to save less and borrow more.	Collect data on interest rates, the rate of inflation, and new housing starts over the past 25 years. State how changes in real interest rates affect people's decisions to borrow in order to buy a house.
Real interest rates normally are positive because people must be compensated for deferring the use of resources from the present into the future.	Explain why people who save money receive interest payments while people who borrow money make interest payments.
Riskier loans command higher interest rates than safer loans because of the greater chance of default on the repayment of the risky loan.	Explain why there are usually differences in interest rates for new and used car loans, or 15-year versus 30-year mortgages, and for individuals with good and bad credit ratings.
Higher interest rates reduce business investment spending and consumer spending on housing, cars, and other major purchases. Policies that raise interest rates can be used to reduce these kinds of spending, while policies that decrease interest rates can be used to increase these kinds of spending.	Identify periods over the past ten years when the Federal Reserve System tried to increase interest rates in order to reduce business investment and consumer spending.