Application report 2

Finance

Interest Rates Inflation can be described as a period when commodities prices increase at a higher than average rate, which is usually between 2-3%. The Federal Reserve keeps a close eye on inflation by evaluating the prices of consumer commodities. In fact, the Federal Reserve uses consumer price index, CPI and the producer price index to monitor the inflation rate. If the inflation rate is higher than 2-3% then the Federal Reserve has the option of either lowering or increasing the interest rates to tip the scale. Interest rates and inflation have an inverse relationship. In other words, if there is inflation and the price of commodities is high the Federal Reserve has to lower the interest rates to make the cost of living affordable and consequently ease on commodity prices. The reverse is also true, in that the Federal Reserve can increase interest rates to avoid inflation.

In this case, the Federal Reserve is grappling with the issue of whether to increase interest rates at a time when the economy is falling apart. At this juncture, the Federal Reserve should not even think about increasing interest rates because the cost of living is already unbearable. Increasing the interest rate would only make the situation worse. This is because consumers would not be able to afford borrowing from the banks. High interest rates discourage people from borrowing from the bank. This is because the federal funds rate is also high too. The federal funds rate is the rate at which other banks borrow money from the federal bank (How Interest Rates affect the stock market, 2009). Therefore, increasing interest would not only affect customer borrowing but would also hurt the local banks that make money by lending loans to their customers. In addition, high interest rates would also mean higher mortgage payments. This is because the mortgage paid out by customers would go up because of high interest rates. Auto loans on the other hand would be expensive because of higher interest rates. The loan payments made every month are usually a product of interest rates and the principal amount therefore would go up as a result. The interest rates could also have some far-reaching implications when it comes to businesses, which are seeking to expand. High interest rates would discourage business from expanding due to unfavorable rates and this could have a ripple effect on the economy. This could have a negative effect on the economy as a whole. The stock market survival depends on perception. In a period when the interest rates investors, tend to be bearing about the market because of the uncertainty of stock prices. Interest rates affect the way business conduct their business operations. In some cases, when the interest rates are high companies incur huge losses due to high financial costs and this ends up affecting the stock prices. Some investors, however, take advantage of high interest rates and invest their money on risk free securities. Such securities include treasury bills and government bonds, which offer a guarantee on return on investments. The only downside to such investment is that the government pays the cost of borrowing money from investors. In addition, the investors who would have either spent their money or invested it in other companies fail to do so in an effort to mitigate risk.

For the case of home and auto loans, high interest rates would increase the cost of living. For example, say, John Doe has a car that has a principal balance of $ 20000 on a car lease at 10% interest rate. If the rate increases to 12%, John's interest rate would raise by $ 400 a year. This would mean that John would have to forego some niceties in order to meet his expenses assuming that John has a tight budget.

The present and future value would go down since the interest rates are higher. For the case of the present value, the high rate of discounting would make the present value lower. On the other hand, the future value would be higher due to a higher rate. However, due to increased cost of living the effect would be cancelled out.

The same effect would be realized on the net present value. This is because the new rate would be effective and would be used in discounting the net present value. The effect would be a lower value because of a higher interest rate.

As far as the weighted average cost of capital is concerned, a company may either report lower or higher capital cost. This is because the cost of capital depends on the companies investors. Investors may choose to put their money in risk free securities or they may choose to keep it in the Company. If they keep it, the Company may feel lucky because they may not need to borrow from financial institutions and therefore they may record lower costs. The cost of capital would be higher if the investors withdrew their funds forcing the company to borrow funds at the new interest rates.

Finally, corporate earnings would either go down or go up because of high interest rates. This is because; a corporate may be depending on a financial institution such as bank for financing. If this is the case, the cost of operations may be higher. The same could be experienced if the corporate has an investment that is earning an interest at the adjusted new rates and this may be a plus for the corporate.

References

How Interest Rates affect the stock market. (2009, May 26). Retrieved on October 5, 2012, from http://www. investopedia. com/articles/06/interestaffectsmarket.

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