Federal reserve system, interest rates and money supply (slp)

Business

Impact of Interest Rate Changes Impact of Interest Rate Changes inserts his/her Impact of Interest Rate Changes The paper discusses how the recent changes in interest rates made by the Federal Reserve have affected any consumer buying decisions such as buying a new home, refinancing a home, financing a new car, saving more money in bank, etc.

Income is a hybrid of savings and expenditures where savings and expenditures are in inverse relation to each other. Changes in major economic variables have a significant impact on the consumer spending. For example, higher interest rates increase the savings and affects consumer spending. According to Engels Laws, with the rise in income, the percentage of income spent on food decreases but the percentage spent on housing remains constant. By increasing the interest rates Federal Reserve attempts to condense the supply of money by making it more expensive to obtain. There is no immediate effect on market with the increase in interest rate. However what happens immediately is that it suddenly becomes more costly for banks to borrow money from the central banks pushing the banks to increase the interest rates for lending money to their customers. (Siddhartha Jha, 2011)

Expenses necessary for the survival are called committed expenses. As these expenses are mandatory, there purchasing decisions are not affected by fluctuations within the interest rate environment. Further, such expenses are met against cash so interest expenses are not applicable. Committed expenses include rent, transportation, groceries, and health insurance, telephone and electricity bills.

Expenses associated with consumer goods, which depreciate quickly and rarely add value to one's bottom line are called discretionary expenses. Expenses on designer clothes, vacation packages, high-end electronics and memberships to exclusive clubs are discretionary expenses. With the rise in interest rates discretionary spending reduces sharply because higher interest rates increase financing costs and lower disposable income. (John Bates, 2011)

Spending on big ticket items expenses like purchasing a car or financing a home is encouraged with stable incomes and low interest rates. The spending decisions for big-ticket items are more so affected by the overall economy because despite a low-interest rate environment, one would be unlikely to take on a mortgage to buy a new home, if one's job is in jeopardy. On the contrary, a strong economy and impressive stock market returns encourage raising cash to purchase a luxury car. Lower interest rates on real estate loans are better for the real estate market in general because it allows more people to purchase more expensive homes. However the negative about low interest rates is that it tends to shove prices of homes higher because there are more buyers.

The existence of interest let the borrowers to spend money immediately, instead of saving the money to make a purchase. The lower the interest rate, the more fervent people are to borrow money to make big purchases, such as houses or cars. With less interest payments consumers have more money to spend which creates a ripple effect of increased spending throughout the economy. Businesses and farmers also benefit from lower interest rates, as it promotes purchases of large equipment due to the low cost of borrowing. (Thomas Sowell and Tom Weiner, 2010)

Conversely, higher interest rates mean that consumers must cut back on spending because they dont have as much disposable income. Higher interest rates coupled with increased lending standards diminish bank loans affecting not only consumers, but also businesses and farmers, who cut back on spending for new equipment, which ultimately slows productivity.

References

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John Bates, 2011, Essentials of Economic Theory, As Applied To Modern Problems of Industry and Public Policy, Nabu Press

Thomas Sowell and Tom Weiner, 2010, Basic Economics, Fourth Edition: A Common Sense Guide to the Economy Blackstone Audio, Inc.