What it means to raise the interest rate

On 16 July 2019, State Bank of Pakistan announced a new monetary policy in which they raised the interest rate from 12.5 percent to 13.5 percent for the next two months of FY 19.

An interest rate of any country is the rate set by the central bank through which it influences the evolution of main monetary variables in the economy (For example, Consumer prices, Exchange rates, etc.). Interest rate is the rate at which private or small banks obtain money from the Central bank to offer their financial products to their respective consumers. There are various factors that influence the change in interest rates of a country such as the supply and demand of money in a country. For instance, an increase in the interest rate leads to a decrease in money supply. The government of the country raises the interest rates in order to control the economy.

But the question that stands is how do interest rates effect local businesses? The answer to this is simple: Banks would charge more on commercial loans, with the increase in interest, which would result in a business that would have to pay more on its earnings, which would lead to less profitability. High interest rates discourage investors to spend in new projects and expansions; this certainly hampers the growth of a company or country.

On the other hand, if the interest rate is kept low, businesses would have to pay less interest over their borrowings from the banks. Businesses grow as their profitability grows and such periods encourage growth in businesses and economies and leads towards stability. The new businesses can now earn enough to pay off their debts and end up with profits in hand.

While discussing the ease of fiscal and monetary policies on the general public, they would have to pay higher interest rates on their current loans for their properties, cars or other consumer goods. Higher interest rates lead to lesser profitability and savings for the common man. This reduces their purchasing power of daily life products and services, which may lead to sufferings for businesses. Contrary to this, if the interest rates are kept low, common men tend to make more purchases of daily products and services which inevitably leads to more profitability for local businesses.

But why would government introduce such policy? Well, it is to attract the businesses to invest their cash that they have in excess in bank accounts to make more money out of it. If the interest rate is kept higher, the businesses would take out their excess cash from the market, which is of no use there, and invest them in banks, resulting in improving the economic conditions of the country. Contrary to this, when the interest rates are kept low, businesses do not invest in bank accounts and hence, their excess cash inflow go to waste. However, they might invest the same excess cash in installing new plants and expanding their base.

A major drawback for this policy on the other end is that when banks do not find an opportunity in the market to invest money and earn reasonably more, they become less likely to take risks on commercial and personal loans. Particularly, it might lead towards troubles for new businesses or small businesses to make borrowings from banks. It discourages businesses to expand and grow more.

In short, it discourages the banks to make short term loans that businesses borrow to cover cash flow problems, and it makes it difficult for businesses to survive in the market and deliver products and services at their best. It often leads small businesses to cease operations since they do not have cash to continue surviving. It might end up making markets more unsaturated, resulting in the cash flow towards the businesses which are already stable enough to tackle such issues as they have a healthy capital. It ends the road towards stability for small or new businesses.