Interest rate

The cost of hiring money or credit. The rate of interest is the amount of interest per unit of time, typically one year. Thus, at 1% per annum, the borrower of $100 would annually pay the lender $1 (for which, in 2013, a time of famine in interest income, the lender might actually be grateful).

There is no one rate of interest but, rather, a myriad of rates. Interest rates vary to reflect the ability and willingness of borrowers to meet their obligations and the ease with which a borrower's promissory note or bond, mortgage, debenture or other evidence of indebtedness can be turned into money. The level of interest rates reflect the quality of the money in which a debt is denominated, the rate at which the lender and borrower are taxed and the confidence in which investors hold the relevant fiscal and monetary authorities.

Lending at interest was condemned by Plato and Aristotle, Cato and Plutarch. The canonical laws of the Middle Ages forbade it, with the Council of Vienne (1311) declaring, according to the 1912 Catholic Encyclopedia, "that if any person obstinately maintained that there was no sin in the practice of demanding interest, he should be punished as a heretic." But years passed, and the "best authors" came to acknowledge "the lawfulness of interest to compensate a lender for the risk of losing his capital, or for positive loss, such as the privation of the profit which he might otherwise have made, if he had not advanced the loan," relates the same authority.

The encyclopedia here touches on ideas developed by the American economist Irving Fisher (1867-1947). Fisher proposed that the rate of interest is determined by the "impatience to spend income" and the "opportunity to invest it," two distinct and opposing human forces. He defined the rate of interest as a financial bridge over time, as the "link between income and capital." It is the premium paid on money "in terms of money to be in hand one year later," as Fisher wrote in "The Theory of Interest," published in 1930.

In the United States, interest rates have risen and fallen at generation-length intervals. Broadly, rates fell from the Civil War to 1900, rose to 1920, fell to 1946, rose to 1981 and have fallen ever since. In outline, the intervals correspond with the rise and fall of average prices. Falling prices have corresponded with falling interest rates, and vice versa.

But the overlap between the trends in average prices and average interest rates is by no means exact. Conditioned by long-trending markets in fixed-income securities, investors are inclined to look backward to familiar experience rather than forward to a change in financial direction.

Thus, in 1899, the president of the Equitable Life polled scores of Wall Street personages to ask what he might expect to earn per annum on high-grade bonds over the next generation. Yields had been falling for almost 35 years; what might the future hold?

To a man, the 69 respondents agreed that interest rates would decline or remain the same, when, in fact, they were poised to begin a 20-year uptrend. The change in the direction of interest rates coincided with a change in the direction of prices, which stopped dwindling and began rising. With the outbreak of war in 1914, the rate of rise accelerated. Presently, real, or inflation-adjusted, bond yields were substantially below zero.

Fast-forward now to the spring of 1984. Inflation had peaked at 14.6% in 1980. The Federal Reserve

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had scotched inflation by shutting off the growth in money supply. Yet lenders and borrowers, recalling all too well the 35-year bear market in bonds (1946-81), set the yield on 30-year Treasurys at more than 13%--this at a time when the CPI was registering year-over-year gains of less than 5%.

In the early 1980s, interest rates were higher than they had ever been. At this writing, in May 2013, interest rates are almost as low as they have ever been, while central banks are more aggressively easy than they have ever been in times of peace. If a new up cycle in interest rates were in the cards, one could imagine it beginning at a juncture such as this.

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