

21.1: The Interest of Interest

Learning Objectives

- What is interest and why is it important?

Interest, the opportunity cost of money, is far from mysterious, but it warrants our careful consideration because of its importance. **Interest rates**, the price of borrowing money, are crucial determinants of the prices of assets, especially financial instruments like stocks and bonds, and general macroeconomic conditions, including **economic growth**. In fact, **ceteris paribus** (like your grades!) the probability of you landing a job upon graduation will depend in large part on prevailing interest rates. If rates are low, businesses will be more likely to borrow money, expand production, and hire you. If rates are high, businesses will be less likely to expand or to hire you. Without a job, you'll be forced to move back home. Best to pay attention then!

Interest can be thought of as the payment it takes to induce a lender to part with his, her, or its money for some period of time, be it a day, week, month, year, decade, or century. To make comparisons between those payments easier, interest is almost always expressed as an annual percentage rate, the number of dollars (or other currency)^[1] paid for the use of \$100 per year. *Several ways of measuring interest rates exist, but here you'll learn only **yield to maturity (YTM)**, the method preferred by economists for its accuracy.* The key is to learn to compare the value of money today, called **present value (PV)** (represented here by the variable PV and aka present discounted value or price), to the value of money tomorrow, called **future value (FV)** (represented here by the variable FV).

KEY TAKEAWAYS

- Interest is the opportunity cost of lending money or the price of borrowing it and can be thought of as the payment a borrower needs to induce him, her, or it to lend.
- Interest is important because it helps to determine the price of assets, especially financial assets, and to determine various macroeconomic variables, including aggregate output.

[1] fx.sauder.ubc.ca/currency_table.html

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