Investors' Confidence and Investment Period: Key Variables for Interest Rate Policy Effectiveness

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Abstract: This article seeks to augment works by both contemporary and conventional economists, on the effectiveness of interest rates on money supply in an economy. This paper, presents the significance of investors' confidence and investment period as key variables on ensuring the effectiveness of interest rate as a policy for regulating money supply in an economy.

Keywords: Interest Rates; Investors Confidents; Investment period

1. Introduction

This monograph seeks to augment some avowals that were made by both contemporary and conventional economists, on the effectiveness of interest rates as a policymakers' chest toolkit in the determination of plausible money supply in an economy. The long lasting inductive and deductive reasoning from the monetarists' school of thought, is that increased money supply is inflationary, which is undesirable in any economy, hence, the use of interest rate variations as a monetary policy tool. This paper, however, explain the significance of investors' confidence

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and investment period as key variables on ensuring the effectiveness of interest rate as a policy for regulating money supply in an economy.

2. Background of the Paper

Interest rate determination has dominated much of monetary policy since the Second World War[1]. Variations in interest rate were important means of helping to secure money supply targets when these were first introduced in the later 1970s. In this sense, a key technique for controlling monetary growth has been to influence money demand rather than money supply [2].

Effects of Interest Rate Variation as a Policy

By lowering interest rates, the central bank could hope to encourage economic activity by decreasing the cost of borrowing, and hence increasing the demand for loans, while conversely, raising interest rates would discourage borrowing. Most of the weapons of monetary policy will indirectly affect interest rates, but the central bank has a direct influence upon interest rates because, as lender of last resort, it guarantees the solvency of the financial system.

Furthermore, higher interest rates may attract inflows of funds from overseas, thus making it more difficult to control the money supply. In addition, the inflow of funds from abroad increases the demand for the currency and pushes upto its value, the rise in exchange rate makes imports cheaper, with exports becoming more expensive, thus creating or enhancing a current account deficit on the balance of payments. It follows, therefore, that the use of interest rate as a monetary policy instrument is contextual, that is, depending on what needs to be addressed.

Implications of Investors' Confidence and Investment Period on Interest Rates Effectiveness

(a) Investors' Confidence

It was suggested by other contemporary economists such as Fischer (1991) who suggested that decreasing the interest rate may not encourage investment, through increased borrowing but that raising the interest rate tends to lock up liquidity in the financial system. This paper contends that businesses, however, might still be willing to borrow at a relatively high rate of interest if they are sufficiently confident that the return on investment is high. In fact, some investment decisions may be considered non-marginal, that is, the entrepreneur will be anticipating a sufficiently large return on investment, that small changes in the interest rate are unlikely to make a potentially profitable scheme unprofitable.

(b) Investment Period

Furthermore, in considering the implication of interest rate in the economy, we must also take account of the effect of time or period on investment decisions. The longer the term of an investment project, the greater the proportion of total cost interest will represent.

In fact, government(s) from 1980’s onwards, believed in using market forces as much as possible. They, therefore, came to view restriction of the money supply as unhelpful. The money supply is, therefore, principally bank deposits, and in turning away from trying to control the size of bank’s balance sheets, it will be like abandoning, “portfolio constraints”.

3. Conclusion

Given the roles that can be played by confidence and time or period in the effectiveness of interest rates, it is, of paramount importance that policymakers spell out the objective that the interest rate seeks to achieve. If the objective is not clear the policy would end up providing a prescription mix which would be undesirable for the economy. It goes without saying, however, that there are factors which make governments unwilling to face high interest rates. With a large national debt to service, raising interest rates increases government’s own expenditure, through provision of subsidies to enhance provision of key services to the economy, a concept referred to as ‘…financial repression’, which both conventional and contemporary economists argue that it negatively impacts on economic efficiency.

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