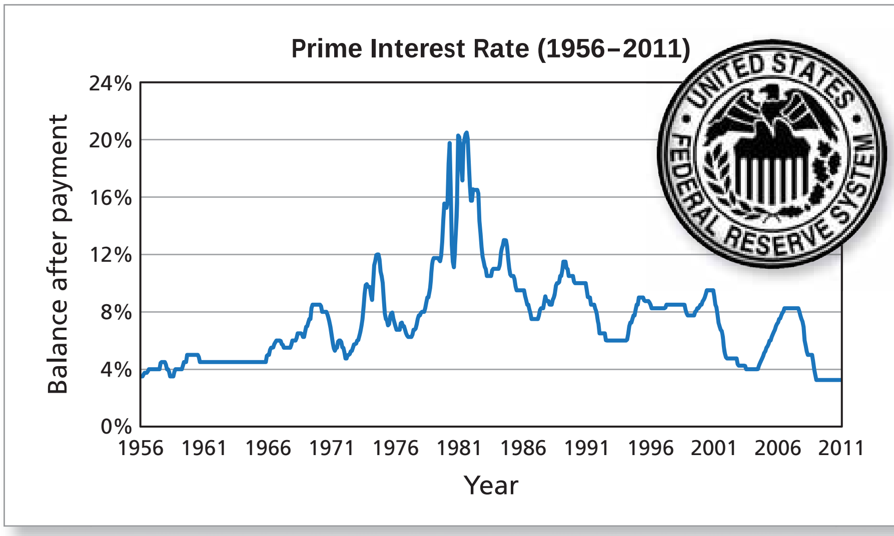
Analyzing Credit in the United States

The **prime interest rate**, or prime lending rate, is the rate that banks charge their most creditworthy customers.



Study Tip

The Federal Reserve System, or simply "The Fed," is the central banking system of the United States. It was created in 1913 by the Federal Reserve Act. Its duties are to conduct the nation's monetary policy, supervise and regulate banking institutions, maintain financial stability, and provide financial services to depository institutions.

EXAMPLE 5 Tracking the Prime Interest Rate

Use the graph above to discuss why interest rates increase and decrease.

SOLUTION

Here are three factors that cause interest rates to fluctuate.

1. **Supply and Demand of Funds:** If the demand for borrowing is higher than the funds that banks have available, then the rates increase. If the demand for borrowing is lower than the available funds, then the rates decrease.
2. **Monetary Policy:** Sometimes the federal government "loosens monetary policy" by printing more money. This causes interest rates to decrease because more money is available to lenders.
3. **Inflation:** Investors want to preserve the buying power of their money. When the inflation rate is high, investors need a higher interest rate to consider lending their money.

Alan Greenspan is an American economist who served as chairman of the Federal Reserve from 1987 to 2006.

✓ Checkpoint

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Which of the following has had the greatest impact on the prime interest rate?

a. **Political party of the president:** 1961–1968 (D), 1969–1976 (R), 1977–1980 (D), 1981–1992 (R), 1993–2000 (D), 2001–2008 (R)

b. **Country at war:** Vietnam War (1965–1973), Persian Gulf War (1990–1991), Iraq War (2003–2010)

c. **Inflation rate:** See page 162.

Justify your reasoning in words and graphically.