Answer on Question #44216 – Economics – Microeconomics

Task

If the government imposed a federal interest rate ceiling of 20% on all loans, who would gain and who would lose?

Solution

Interest rate ceiling is the maximum interest rate that a financial institution can charge a borrower for an adjustable rate mortgage or loan according to the contractual terms of the mortgage or loan. This interest rate is expressed as an absolute percentage. For example, the terms of the loan might state that the interest rate can never exceed 20%. An interest rate ceiling is sometimes used interchangeably with the term "lifetime interest rate cap". However, an interest rate cap is usually expressed as a maximum change allowed in an initial interest rate.

The impacts of interest rate ceilings on credit supply:
•Lenders cannot afford to cross subsidise high risk borrowers without risking their competitive position.
• In markets without price controls specialist lenders meet demand for small sum credit, typically provided at high cost to high risk borrowers.
• Such lending models do not develop or lenders withdraw in markets where price controls are introduced.
• The impact of price controls is evident in both the diversity of credit products offered in a market and in the extent of credit rationing.
• Where ceilings are effective in containing price, lenders withdraw from markets where they cannot lend profitably.
• Lenders in these markets also set minimum lending levels higher than is appropriate to the needs of low income households and high risk borrowers.
• The constrained credit product mix in price capped markets leads borrowers to use products which are less suited to their needs and expose them to greater risk
• Where ceilings are imposed those without options are diverted to pawn – and illegals – while others are primarily diverted to mainstream revolving credit.
• Illegal lending tends to arise in a credit vacuum, is frequently associated with other criminal activity and is both very high cost and damaging to victims.
These effects are readily observed in markets with and without ceilings, as the differences are in outcomes for consumers.