**Interest Rate Differentials**

There are seven main causes of difference in interest rate. These are: 1. Differences in Risk 2. Period of Loan 3. Volume of Loan 4. Nature of Security 5. Financial Standing of the Borrower 6. Market Imperfection 7. Variation in Demand and Supply of Money.

1. **Differences in Risk:**

Gross interest rates differ owing to the differences in risk and inconvenience involved, cost of maintaining accounts of borrowers, toil and trouble associated with the business of lending, etc. The greater the risk and inconvenience, the higher is the rate of interest. A Kabuliwala usually charges high rate of interest compared with banks because the former sanctions loan without asking any security.

1. **Period of Loan:**

Generally, longer the duration of loans the higher will be the interest rate. Loan sanctioned for a long period usually carries high interest rate since money or capital is locked for a long time. A short period loan carries a low interest rate.

1. **Volume of Loan:**

Rate of interest also depends on the amount of loan. Usually, a borrower pays low interest if he borrows larger amount of money. A small amount of loan may be available if a high rate of interest is paid.

1. **Nature of Security:**

Interest rate varies with the nature of securities offered by the borrowers. Loans against the security of gold or government bonds carry less interest since these securities can easily be converted into cash by the lenders. But loans are also sanctioned by giving securities of immovable properties, like land and house. Rate of interest against those securities will tend to be high since these are not easily converted into cash.

1. **Financial Standing of the Borrower:**

Rate of interest may vary due to the lender’s idea about the financial strength or creditworthiness.

A borrower with known integrity and reputation can get loans at low rates. The reverse will be the case if the credibility of the borrower is doubtful. Usually, whenever government takes loans from its own citizens, it pays low interest rate as no one casts any doubt on the ability of the government to pay back money in due time.

1. **Market Imperfection:**

Market imper­fections seem to be another reason for the variation in interest rates. There is variety of institutions that carry on money-lending business. For instance, banks, insurance companies, house building bank, etc., specialize in different kinds of loans charging different interest rates. A village moneylender enjoys some sort of monopoly power and, hence, charges a high rate of interest.

1. **Variation in Demand and Supply of Money:**

Finally, differences in interest rate may also be due to variation in the demand for money and supply of money in different markets. Nature of agricul­tural loan is different from industrial and commercial loan. Obviously, conditions of demand for and supply of money are different—thereby causing differences in interest rate.