What is interest?

KS2 KS3 Ages 9-14 ⏰ 3 min read

Whenever you borrow money, you pay back more than you borrowed. That extra amount is **interest**. It's essentially the price the lender charges for letting you use their money. And when you save money in a bank, you earn interest — the bank pays you for letting them use your money.

How is it calculated?

Interest is expressed as a percentage rate, usually per year. If you borrow £1,000 at 5% interest per year and pay it all back after a year, you owe £1,050. The £50 is the interest — the cost of borrowing.

It gets more interesting (sorry) with **compound interest** — where interest is charged on interest. Borrow £1,000 at 5% compound interest and don't repay anything. After year one you owe £1,050. After year two, 5% is charged on £1,050, so you owe £1,102.50. After 10 years: £1,629. After 30 years: £4,322. Same original debt, grown enormously because interest kept being added to interest.

Compound interest is like a snowball rolling down a hill. It starts small. But as it rolls, it picks up more snow — and the bigger it gets, the more snow it picks up with each rotation. The growth accelerates over time. Einstein reportedly called compound interest "the eighth wonder of the world." Whether he actually said it or not, the maths is real — and it works the same way whether you're the borrower (compounding against you) or the saver (compounding for you).

Why does interest exist?

Three reasons. First, **opportunity cost** — if you lend money, you can't use it yourself during that time; interest compensates for that. Second, **risk** — the borrower might not pay it back; interest compensates for that risk. Third, **inflation** — money loses purchasing power over time; interest compensates for the fact that £1,000 in 10 years is worth less than £1,000 today.

Why do interest rates matter so much?

Because so much of the economy runs on borrowed money — mortgages, business loans, credit cards, government borrowing. When the Bank of England raises its base rate, borrowing becomes more expensive across the whole economy. People spend less, businesses invest less, the economy slows down. This is deliberately used to reduce inflation. It's one of the most powerful levers in economic policy.