eLearneconomics: AD – C + I (1)

Student response

(a) Explain the impact on consumers and producers of an increase in interest rates.

(b) Explain the impact of lower inflationary expectations on household consumption.

(c) Explain the impact of lower inflationary expectations on the level of borrowing by households and household debt.

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Solution

(a) Explain the impact on consumers and producers of an increase in interest rates.

As interest rates increase, consumption spending by households will decrease because savings increase, borrowing falls and mortgage payments increase. Savings increase because the return increases. Borrowing falls because the cost of loans rise. Those with existing loans (variable rates) pay more in interest, reducing funds available for spending.

Investment spending by firms to buy new capital items will decrease because the increased cost of borrowing will increase the risk of failure and mean that new ventures are likely to be less profitable.

(b) Explain the impact of lower inflationary expectations on househoid consumption.

Lower inflationary expectations reduce household consumption spending because it curbs the desire to spend and borrow. Consumption spending by households is likely to fall because there will be less need for spending to take place before prices increase, when inflationary expectations are low. When consumption spending falls household savings increase.

(c) Explain the impact of lower inflationary expectations on the level of borrowing by households and household debt.

Lower inflation rates mean that the real value of any interest paid on debt is increased, making debt less desirable, therefore households will pay down debt and borrow less. Benefits or gains that might have been achieved through the repayment of debt by the falling real value of the sum of the loans borrowed will decline.