PENANG SANGAM HIGH SCHOOL
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LESSON NOTES

Subject: <u>Economics</u> **Year/Level:** <u>13C</u>

Week 7

Strand	3	Macroeconomics
Sub Strand	3.1.2	Analyse the effects of interest rates in the economy
Content Learning Outcome	Explain the effects of interest rates in the economy.	

Greetings to all…

In our last lesson we looked at 'Changes in Money Supply' under strand 3 of Macroeconomics. Now we will focus on the next sub-strand of strand 3 which is effects of interest rates in the economy. As such you will continue with your coverage from where we left.

(Note: You will copy the sub-strand and the content learning outcome in your note book).

<u>Lesson Notes</u> **(To be copied in your Note book)**

Interest Rate is a determinant between savings and investments.

<u>Interest Rate</u>

- Payment for a borrower to a lender
- Act as a cost of borrowing

-Acts as a reward on savings money in a bank

<u>Relationship between Savings and Investment</u> (Inverse Relationship)

- ➢ An increase in interest rate will lead to a decrease in investment.
- ➢ A decrease in Interest rate will lead to an increase in investment.

Paradox of Thrift

It states increasing saving by individual is beneficial, increased saving by all households' will reduce consumption spending and economic activity.

According to Keynes, Paradox of Thrift showed that as people become thriftier, they end up saving less as such if all people in the economy increase their proportion of income as savings (MPS) then value of savings in the economy will decline or remain unchanged.

Example: Graphical Illustration

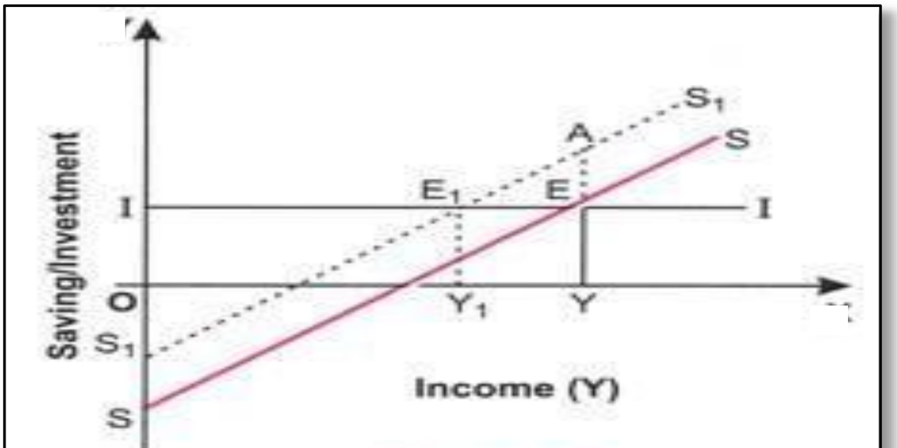

Figure 3.1

Interpretation

1. Point E (Equilibrium level) S=I with income at Y initially.
2. Society reduces consumption to increase savings. Saving curve shifts upwards to S1S1 intersecting investment at E1. (New equilibrium: Point E1).
3. Results into increase in **unplanned inventories** (Unsold stock) and firms will decrease production and employment to Point E1.
4. Planned saving decreased from AY to AY1.
5. At Point E1, investment and savings remain same E1Y1but income falls from Y to Y1.
6. Decline in equilibrium level of income represents Paradox of Thrift i.e. reverse process of multiplier has worked on reducing consumption expenditure.

Activity (Copy and solve in your note book using the above notes)

1. Define Paradox of Thrift?
2. Explain the effect of increase in interest rate on investment by firms?
3. Explain the decrease in interest rates on savings by individuals?

Stay safe