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LESSON NOTES
Worksheet 8

Subject: Economics **Year / Level: 13** **Name: ______________________**

Strand	3 - Macroeconomics
Sub Strand	Investigate how an economy operates and functions to achieve its economic growth.
Content Learning Outcome	Explore the effects of Interest Rates

Students please read pages 100 & 101 from the textbook for greater understanding.

EFFECTS OF INTEREST RATE

Interest is payment from a borrower or deposit-taking financial institution to a lender or depositor of an amount above repayment of the principal sum (i.e. the amount borrowed).

Interest acts as a **reward** for saving money in commercial banks or any financial institutions and on the other hand, it **acts as a cost of borrowing** (taking loans).

Relationship between Investment and Interest Rates

In general, if interest rates are high, investment decreases. Conversely, if interest rates are low, investment increases. This inverse correlation is key in understanding the relationship between the interest rate and investment.

Students therefore if the **int rate** ↑ **inv** ↓
int rate ↓ **inv** ↑

- **Low Interest Rates** - investment in education, infrastructure or business expansion takes money to accomplish. If interest rates are low, students, governments and business can borrow the money they need more cheaply.

- **High Interest Rates** - when interest rates are high, investment becomes more expensive. As money becomes more expensive to borrow, businesses, governments and individuals start slowing their investment plans.

Relationship between Savings and Interest Rates

In theory, interest rate can affect the decision to save in two ways.

- **Substitution effect of a change in interest rate** – lower interest rates reduces the incentive to save because of relatively poorer returns. There is a bigger incentive to spend rather than keep savings.
- **Income effect of a change in interest rate** – lower interest rates reduce the income received from saving, and so people may need to save more in order to gain a reasonable return from your savings. This is important for people thinking of retirement.

PARADOX OF THRIFT

- Paradox of thrift states that increasing saving by individuals is beneficial, increased saving by all households will reduce consumption spending and economic activity.

- Saving is treated as a virtue **(benefit)** by households as they provide a protective umbrella against bad spells but same is treated as a vice **(loss)** by the economy as it retards **(delay)** the process of income generation.

- Keynes pointed out 'paradox of thrift' and showed that as people become thriftier(economical /careful), they end up saving less or same as before.

  If all the people of an economy increase the proportion of income which is saved (i.e., MPS), the value of savings in the economy will not increase, rather it will decline or remain unchanged. Let us understand this statement with the help of the fig. 3.1 Refer to page 101 .

Activity

1. Use the diagram given below to answer the following questions.

a) What does the above diagram illustrate? ____
____(1 Mark)

b) Define Paradox of thrift ____
____(1 Mark)

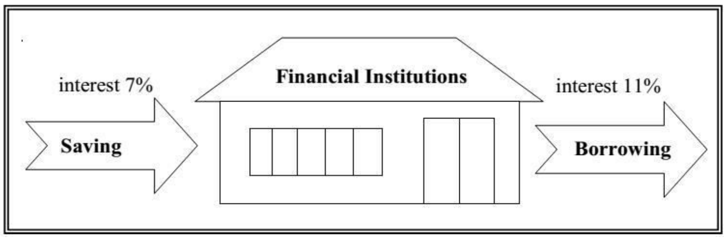
c) Explain the effects of increase in interest rate on
   i. investment by firm; ____(2 Marks)
   ii. Savings by individuals ____(2 Marks)

d) Explain the effects of decrease in interest rates on:

   i. investment by firms; ____(2 Marks)

   ii. savings by individuals ____(2 Marks)

2. Use the diagram below to answer questions (i) and (ii).



i) Define interest as used in the diagram.____(1 Mark)

(ii) Financial institutions charge borrowers higher rates of interest than they offer to savers.

Explain why the financial institutions behave this way.
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____(2 Marks)