Answer on Question#40363 – Economics – Other

Assignment

Outline the possible effects of the cuts in interest rates on economic growth and inflation

Solution

If the Central Bank reduces the base interest rate, this will usually cause commercial banks reduce their own interest rates.

Lower interest rates make it cheaper to borrow. This tends to encourage spending and investment. This leads to higher aggregate demand (AD) and economic growth. This increase in AD may also cause inflationary pressures.

The increase in AD is due to several factors. In theory, lower interest rates will:

-Reduce the incentive to save. Lower interest rates give a smaller return from saving. This lower incentive to save will encourage consumers to spend rather than hold onto money.
-Cheaper borrowing costs. Lower interest rates make the cost of borrowing cheaper. It will encourage consumers and firms to take out loans to finance greater spending and investment.
-Lower mortgage interest payments. A fall in interest rates will reduce the monthly cost of mortgage repayments. This will leave householders with more disposable income and should cause a rise in consumer spending.
-Rising asset prices. Lower interest rates make it more attractive to buy assets such as housing. This will cause a rise in house prices and therefore rise in wealth. Increased wealth will also encourage consumer spending as confidence will be higher. (wealth effect)
-Depreciation in the exchange rate. If the UK reduce interest rates, it makes it relatively less attractive to save money in the UK (you would get a better rate of return in another country). Therefore there will be less demand for the Pound Sterling causing a fall in its value. A fall in the exchange rate makes UK exports more competitive and imports more expensive. This also helps to increase aggregate demand.