The Rate Ripple

Trace how borrowing costs shape growth and prices.

GE.5.5 "Analyze the effects that higher or lower interest rates can have on economic growth and inflation."

NAME _____ DATE _____

1 READ AND MARK

Read it twice

YOUR JOB Underline the steps from lower rates to growth and from higher rates to slower growth, circle each link to inflation, and number two conditions that could change these effects.

Borrowing in Harbor City

1 In Harbor City, a small bakery wants to buy a second oven, and a family wants a home. Both may borrow money. The interest rate is the price they pay for using that money. When rates fall, monthly loan payments can become cheaper. The bakery may buy its oven, hire another worker, and sell more bread. The family may buy the home, giving builders more work. As spending and hiring spread, businesses can produce more goods and services. That increase in production is economic growth. Rate changes do not force anyone to borrow; people also consider their income and expectations.

2 Now imagine many Harbor City shoppers and firms can borrow more cheaply at once. If their spending rises faster than local businesses can expand production, stores may raise prices. Inflation is a sustained rise in the overall price level, not just a higher price for one loaf. A lower rate can therefore support growth while also adding to inflation pressure. That pressure may be weaker when factories have unused machines and workers need jobs, since businesses can meet extra orders without quickly raising prices. These effects take time, and a fall in borrowing costs does not guarantee either growth or higher inflation.

3 If inflation remains high, the central bank may raise its policy interest rate. Other borrowing rates often rise as lenders adjust, though not always by the same amount. The bakery might delay its oven purchase because the loan costs more. Some households might postpone buying homes, so builders receive fewer orders. Slower spending can ease pressure on prices, but it can also slow economic growth and hiring. Higher rates cannot bake more bread or fix a wheat shortage. If wheat costs jump because of a poor harvest, bread prices may stay high even when borrowing and spending cool. The outcome depends on the economy's conditions.

2 ANSWER WITH EVIDENCE

Use the passage

1. If interest rates fall, how could decisions by the bakery and the family lead to economic growth?

2. Why might lower interest rates add less inflation pressure when factories have unused machines and workers need jobs?

3. If the central bank raises its policy rate, what could happen to both economic growth and inflation? Explain the connection.

4. Why might higher interest rates fail to bring down bread prices after a poor wheat harvest?

3 YOUR TURN

Your own words

A town reports rapid inflation and strong sales at its bicycle shops. Recommend a direction for interest rates and write four sentences tracing likely effects on borrowing, spending, inflation, and economic growth, including one reason the outcome might differ.

ANSWER KEY

The Rate Ripple

HIGH SCHOOL · GE.5.5

PART 1 · READ AND MARK

Underline the steps from lower rates to growth and from higher rates to slower growth, circle each link to inflation, and number two conditions that could change these effects. Accept any marking that follows this job and points at the right text.

PART 2 · ANSWERS

#	QUESTION	ANSWER
1	If interest rates fall, how could decisions by the bakery and the family lead to economic growth?	**Cheaper loans may lead the bakery to buy an oven and hire a worker and the family to buy a home. More orders and work can increase production.**
2	Why might lower interest rates add less inflation pressure when factories have unused machines and workers need jobs?	**Businesses can use available machines and workers to meet extra demand without raising prices as quickly.**
3	If the central bank raises its policy rate, what could happen to both economic growth and inflation? Explain the connection.	**Borrowing may cost more, so households and businesses may spend less. That can slow growth and hiring while easing pressure on prices.**
4	Why might higher interest rates fail to bring down bread prices after a poor wheat harvest?	**Higher rates can cool borrowing and spending, but they cannot fix the wheat shortage that raised the cost of making bread.**

PART 3 · YOUR TURN (SAMPLE ANSWER)

I would raise interest rates to try to slow the town's rapid inflation. More expensive loans could lead customers to postpone bicycle purchases and shops to delay expansion, reducing spending. With less demand, overall price increases could slow, but production and hiring might grow more slowly too. If shortages of essential goods are driving many prices up, higher rates may not stop those increases.

Accept answers that trace borrowing costs through spending to both growth and inflation, while treating the outcomes as possibilities rather than guarantees. For Your Turn, accept a different recommendation if the student gives a coherent explanation of its likely effects and a relevant limitation.