



EconoMag

Quantitative Easing©

by Alex Hurst

"... First as regards the key ECB interest rates, we decided to lower the interest rate on the main refinancing operations of the euro system by 5 basis points to zero and the rate on the marginal lending facility by 5 basis points to 0.25%..."

From EnglishWaves radio, this is EconoMag. If you've read any financial news you've probably seen a lot about interest rates. These are the sorts of things that most people who aren't economics nerds tend not to read, mainly because it all seems kind of boring. But interest rates are incredibly important. So important that they've brought down governments and helped to establish empires.

Think about interest rates as the price of money, or the cost of borrowing it to be more exact. When interest rates are low, money is cheap, when they are high, money is expensive. The way that interest rates fluctuate and change is a function of both conditions in the present, and expectations about the future.

During the Eighty Years' War, interest rates played a significant role in the victory of the Dutch Republic over the Spanish Empire. How so? The Spanish Empire, with a history of defaulting on debt, found itself facing high interest rates demanded by potential lenders, and a limited ability to borrow money. The Dutch Republic was able to borrow money at low cost, partly because its representative institutions gave wealthy merchants more confidence that they would eventually be paid back.

What happens today is different, but follows the same principles. Take all of this with a grain of salt, because in economics, things sound simple at a basic level, but there are so many variables and feedback loops that can happen to change the very idealized explanations you find in entry level textbook chapters. But in the hypothetical, central banks can raise or lower the interest rate that they charge when they lend money to private banks. Lowering interest rates makes it cheaper to borrow money, meaning that, under normal economic conditions, investment by firms is likely to increase, which causes a corresponding rise in consumption, and therefore, in GDP. A growing economy leads to lower unemployment and rising wages, which slowly leads to increases in prices, known as inflation. Conversely, when a central bank raises interest rates, borrowing decreases, investment and consumption decrease as the level of saving rises, and the economy cools off, unemployment rises.

So why wouldn't you have low interest rates all the time? Simply put, inflation. Imagine standing on a balance beam — as it tips toward one end of the ground (i.e., inflation),

you have to adjust how you stand on the beam in order to keep it balanced (i.e., raising interest rates), but then as the beam swings to the other side, you have to adjust again in order to prevent recession (so, lowering interest rates).

The second major effect that interest rates have is on the value of currency. Raising interest rates tends to cause the currency to increase in value, because there is greater demand by investors to have that currency. Lowering interest rates causes investors to search for higher returns elsewhere, leading to less demand for the currency, and thus a lower value. So through interest rates, central banks can also affect the value of their currency, which can be important if a country exports a lot to the rest of the world, or needs to import crucial goods.

I'll end with that to let you contemplate all of that information...

From EnglishWaves Radio, this has been EconoMag thanks for listening.