INTEREST RATES

Interest rates are the cost of borrowing money.

A lender must analyze the creditworthiness of the borrower and the borrower's industry.

A lender would analyze:

1. Credit or Default Risk – risk firm may default on loan
2. Interest Rate Risk – risk that interest rates may rise and value of loan will fall
3. Market Risk – risk that industry or broad economy slumps

TYPES OF RATES

Discount Rate – the rate that the bank pays to borrow funds

Prime Rate – the rate banks charge their top customers

Real Interest Rate – Interest Rate minus the Inflation Rate

Risk Free Rate – the interest rate without credit risk – U.S. Treasuries are most commonly used

MONETARY POLICY

Tools used to influence monetary policy:

- **Open Market** (most valuable) – FED buys gov't securities which lowers interest rates

- **Required Reserve Ratio** (RRR) – change the level of reserves banks must hold, lower reserve requirements results in more money to lend

- **Discount Rate** – lowering discount rate encourages bank to borrow more

The Federal Reserve may choose to tighten or loosen monetary policy depending on economic conditions:

Loosen Money

- recession coming
- FED buys government securities which puts more money into circulation
- lower required reserve ratio (more money to lend
- Lower interest rates

Tighten Money

- Inflation coming
- Sell government securities
- Increase required reserve ration
- raise interest rates

MONEY SUPPLY

Money supply consists of **M1 + M2**

M1-currency (paper money & coins), checking accounts

M2- Savings accounts (including money markets), small time deposits (less than 100K), non-checking savings, mutual funds

Excess Reserves and the Money Multiplier

A single bank can lend their excess reserves. An entire banking system can lend their excess reserves X money multiplier.

Money Multiplier:

1 ÷ Reserve ratio

TRADE BARRIERS

Tariffs

- Taxes imposed on imported goods (protect domestic producers and discourage foreign consumption).
- Results in higher prices for imported goods.

Import quotas

- Set fixed limits on different products (domestic employment and prices ↑).
- Balance of payment ↑ in short run

Embargos

- total ban of imports (extreme)

Voluntary exports

- reduce products available in foreign county (used to avoid official sanctions)
- Trigger price-tariff on unfairly cheap imports
- Prices are driven ↑ for both import quotas & tariffs

Arguments in Favor of Protectionism

- Reduced imports protects against domestic jobs
- Industries essential to national security
- Infant industries need protection in the early stages of development

Economic Cost of Protectionism

- Real wages and world output declines

- Workers are shifted from efficient export industries into less efficient protected industries

Domestic content rules

- Requires that a portion be made domestically.
- usually applies to capital intensive industries – eg cars

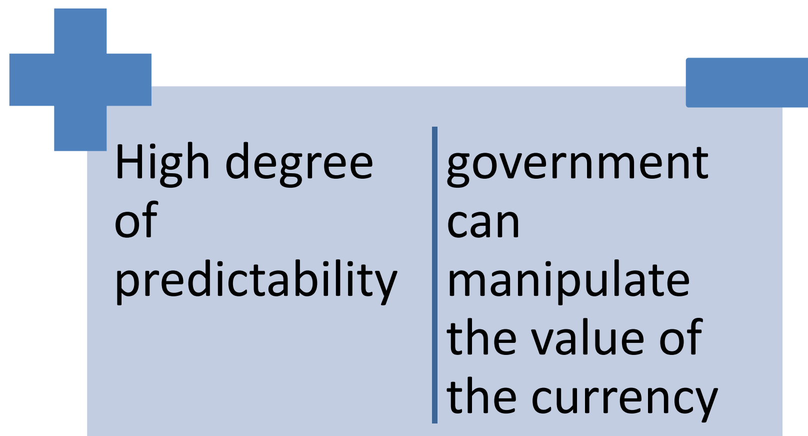
Dumping

- charge an artificially low price to drive out competition
- lower than its home market
- less than the cost to make it

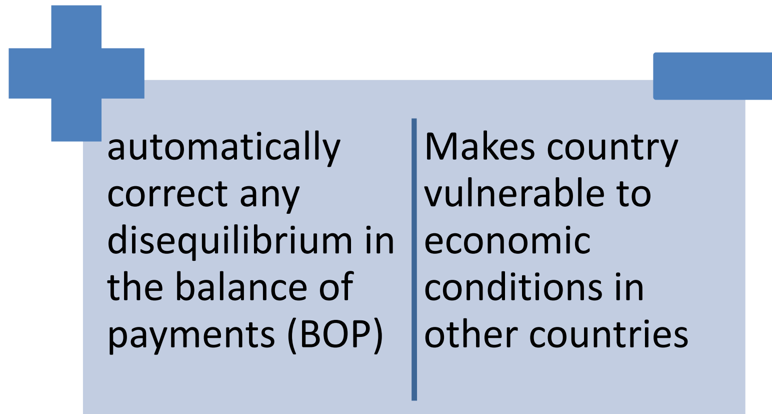
CURRENCY EXCHANGE RATES

There are three main types of exchange rate policies:

Fixed: currency is fixed or allowed to fluctuate in a narrow range.



Freely Floating - determined by market forces of supply and demand



Managed Float (used by major trading nations) - government allows market forces to determine rate until they move too far in one direction. The government will intervene at that point.