Answer to the Question #83322, Economics / Microeconomics

How a rise in the rate of interest might cause a shift in an economy's aggregate demand curve?

Answer: First of all, it is better to define the aggregate demand and interest rate to understand their relationship. The interest rate is the cost of borrowing and the benefit of saving. On the other hand, aggregate demand is the total demand for goods and services in an economy at a given time which can be expressed by using the national income identity.

$$AD = C + I + G + EX - IM$$

Where, "C" is the consumption, "I" investment, "G" government spending, "EX" exports and "IM" imports. By using this identity we can easily answer the question.

If interest rates increase, it becomes more expensive to borrow money (since there is a larger amount to be paid back on top of the value of the loan) and more beneficial to save money (since banks will pay more for saving). This means that consumers are less likely to take out loans and more likely to store their money in the bank, leading to a reduction in consumption—less consumer spending, more saving. Likewise, with firms, which will be less likely to invest in new capital (because borrowing funds to buy it costs more) and more likely to save profits. This reduction in consumption and investment means that aggregate demand falls, represented in a diagram by a shift to the left and this will lead to the reduction real GDP.