Handout

Money and its price (interest)

Note: Before working with this handout, please read Money and its value (inflation) and Measuring inflation.

Task 1: ECB

Please indicate whether the following statements about the ECB are true or false and correct any false statements.

Statement	True	False	Correction
(1) The ECB aims for an inflation rate of 0% over the medium term to ensure that there is neither inflation nor deflation.		x	The ECB aims for an inflation rate of 2% over the medium term as low inflation supports economic growth and prevents deflation.
(2) The interest rates banks charge for granting loans (lending rates) are usually lower than those they pay for customer deposits (deposit rates).		x	Lending rates are higher because, otherwise, the bank would earn nothing.
(3) The ECB's key instrument in fighting inflation is the main refinancing operation.	x		
(4) If the ECB raises its key interest rates, demand for loans increases and prices fall.		x	Demand for loans declines because rising interest rates make loans more expensive.

Task 2: Causes of inflation

Please indicate whether the following statements are examples of supply- or demand-side inflation and identify the type of inflation as precisely as possible.

Example	Supply-side inflation	Demand-side inflation	Type of inflation
(1) Last year, the rise in energy prices forced many companies to raise the prices of their products.	x		Cost inflation

(2) Retail sales rose rapidly in the short term following the lockdowns during the COVID-19 pandemic.		x	Consumer inflation
(3) The competition authority inspects food retailers as they plan to raise food prices above the inflation level because of their favorable market position.	x		Profit inflation
(4) There were problems with many supply chains during the pandemic. That's why many raw materials became more expensive.	x		Cost inflation

Task 3: The effects of inflation

Please indicate whether high inflation has positive or negative effects for the following economic agents and explain your answer.

1. Ms. Samuel took out a loan with fixed interest rates during a period when interest rates were low. After four years, she still owes the bank EUR 201,000. Meanwhile, inflation is high and interest rates are rising.

Positive effects	Negative effects	Why?
x		Fixed interest rates remain unchanged even in times of high inflation, while key interest rates will rise. Moreover, the real value of the loan decreases. If income is adjusted for inflation, it will be easier to repay the loan.

2. Sebastian's total savings of EUR 20,000 are in a savings book and in his current account.

Positive effects	Negative effects	Why?
	x	Assets in current accounts or savings books are not protected against inflation. They might lose value (purchasing power) as interest income may not be able to keep up with the inflation rate.

3. Ms. Saalbacher owns several apartment buildings in Baden bei Wien, a town near Vienna. The rental contracts with her tenants state that rents will be adjusted to the consumer price index (CPI).

Positive effects	Negative effects	Why?
X		Owners of nonfinancial assets (like real estate, for example) are hardly affected by inflation. The rental contracts ensure that Ms. Saalbacher's rental income is adjusted for inflation. This means it is protected against inflation.

4. During the COVID-19 crisis, the Austrian government took on a lot of new debt to finance measures to overcome the crisis.

Positive effects	Negative effects	Why?
x		Inflation reduces government debt because the real value of debt decreases in times of high inflation.

5. The Steiners took out a loan with variable interest rates from their bank several years ago. They still have five years of repayments left.

Positive effects	Negative effects	Why?
	x	When key interest rates rise, variable interest rates rise as well. That also means that loan repayments for variable-rate loans will become significantly more expensive.