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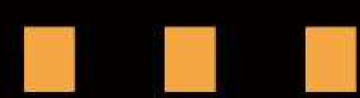

Interest Rate and Inflation

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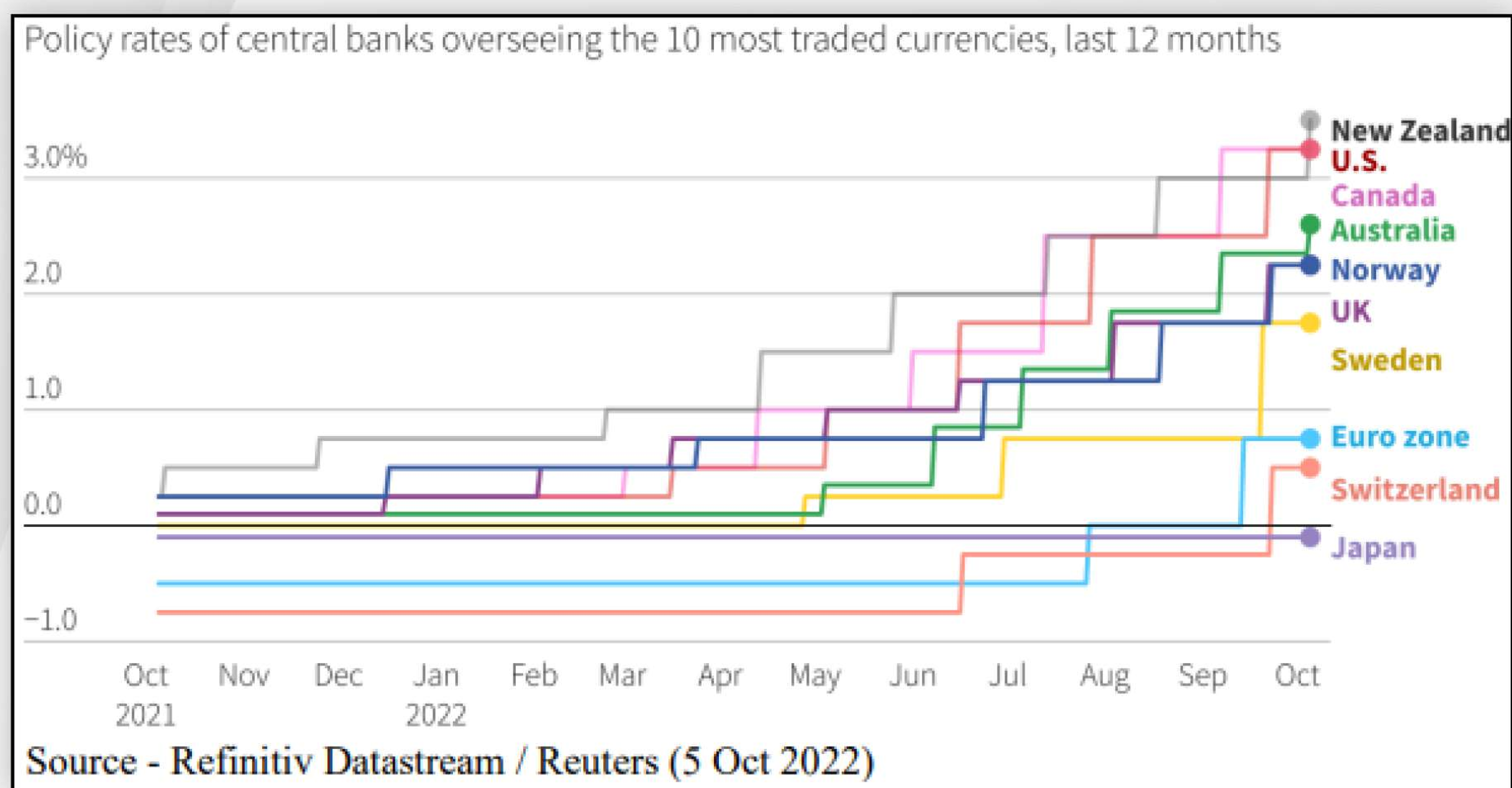
Inflation is a key risk in the current business cycle and is tilted northbound. From Central Banks to property investors, everyone is terrified of stubbornly high inflation and its effect on the economy. Apart from China, Russia and Japan, all other central banks around the world have responded with aggressive interest rate hikes

From a layperson's perspective, it is not inaccurate to assume that interest rate and inflation are in an Inverse relationship

When the central banks respond to inflation risks by raising the interest rates, it effectively increases the level of risk-free reserves in the financial system, which limits the money supply and discourages consumer & business spending. Conversely, when it reduces its target interest rate, it effectively increases the aggregate demand. The approach currently adopted by most central banks worldwide is consistent with John Maynard Keynes's economic theory, also known as Keynesian economics.The oversimplified Keynesian economics explanation suggests that government interventions are necessary to moderate the effects of the business cycle, which can also be interpreted as intervening in the money supply, i.e.,interest rates.

The strong policy response seems to have worked well during the 2008-09 crisis and discredited the optimally self-adjusting economic theory. Despite of failure of Keynesian economics in the 1970s stagflation phase, it still plays a dominant role in policymaking.

A 1982 NBER (National Bureau of Economic Research) paper, 'The Non—Adjustment of Nominal Interest Rates: A Study of the Fisher Effect', concludes that there is no evidence that interest rates respond to inflation in the way that Keynesian theories suggest. Even the Reserve Bank of Australia's (RBA) 1991 research paper remains inconclusive about the nature of the relationship between interest rates and inflation. It is clear that inflation and interest rate is not a zero-sum game.



Source - Refinitiv Datastream / Reuters (5 Oct 2022)

In March 2022, the RBA indicated inflation to be around 3.25% for the rest of the year and go down by 2023. Despite multiple rate hikes after that, in September, inflation was at an all time high in the three decades at 7.1%, with a possibility of rising higher. Despite all the evidence, RBA, In accordance with its monetary policy, has used its only weapon - interest rate control, again and again. Such an active role in controlling aggregate demand means going ahead, RBA has to trade-off between unemployment and inflation.

The artificial change in aggregate demand is a handy tool for the short term, but it is not a long-term solution. Even Keynes was aware of it and argued, "In the long run, we are all dead." to make the point.

After a slower inflation growth in the US on 13th October, RBA still expects a window of opportunity to play the waiting game before any further tightening. There is no doubt that the interest rate is an essential tool to fight against inflation, but there is doubt over its efficacy over the longer term.

It is evident that inflation and interest rates are intertwined, but inflation is a lagging indicator. It would be interesting to see how RBA and other central banks drive the economy forward while looking into the rear-view mirror