Q. How do Inflation and Interest Rates Affect the Economy?

by Tom Fullerton and Doyle Smith

Of the many topics covered on a daily basis by the international business press, the two that probably receive the most attention are inflation and interest rates. While the recognition factor for these two topics is undoubtedly very high, occasional misconceptions arise with respect to each of them. This article reviews their meanings and examines how they affect economic performance.

Inflation is defined as an increase in the average price level for the goods and services traded in an economy. In economies such as the United States, inflation is almost always reported on an annualized basis. In such an approach, the price change under consideration is calculated in terms of what it would be if sustained over a 12-month period. In economies where inflation has historically been fairly high, monthly inflation rates are also frequently used.

In addition to inflation, several related terms also receive periodic coverage by the business press. Hyperinflation describes situations of extremely rapid price growth such as Germany during the 1920s and Brazil during the 1990s. The generally accepted numerical definition of hyperinflation is a rate of increase of 50 percent or higher in a single month. At the opposite end of the spectrum, deflation is defined as a decrease in the average level of prices. Deflation occurred in the United States in the 1930s and in both Argentina and Japan in the 1990s. Often confused with deflation, disinflation refers to a situation wherein the rate of inflation is still positive, but is lower than it was in preceding periods. For example, if inflation falls from 40 percent in one year to 30 percent the next year and 20 percent the following year, prices are still increasing but at progressively slower rates. Disinflation was observed in the United States during the mid-1980s and also occurred in Mexico during the late 1990s.

Because it is reported on a monthly basis and measures price changes for goods and services purchased by typical households, the most widely quoted measure of inflation is the consumer price index. From 1992 forward, the CPI in the United States has increased at annual rates of 3.4 percent or less. Such price stability has not always been observed in this country. For example, oil price surges and rapid money supply growth helped cause double-digit rates of inflation in 1974, 1979, 1980, and 1981.

Businesses and governments usually operate more efficiently with low rates of inflation. Some countries such as New Zealand have occasionally even tried to completely eliminate inflation. The reason inflation is so unpopular is that market economies rely on prices to provide accurate signals with respect to business performance and investment opportunities. When prices in general increase by several percentage points or more, it becomes more difficult to determine which individual price increases are caused by superior business outcomes. In addition, the likelihood of investment mistakes is greater during periods of escalating prices. Investor uncertainty also rises under these circumstances because of concerns about government policy actions that may or may not reduce price pressures.

An important consequence of inflation is that it has a significant impact on interest rates charged by banks and other organizations on loans. Interest rates also determine the payments received by investors who purchase financial instruments such as corporate or government bonds. Both types of yields are measured as percentages of the money loaned or invested.

Inflation rates directly influence nominal interest rates. Nominal interest rates, also known as market rates, represent a real rate of return plus a premium for the expected rate of inflation over a given period of time. Similar to inflation, interest rates in the United States are usually quoted in annualized terms. Real interest rates are calculated by subtracting the inflation rate from the nominal interest rate. Investors and financial companies seek positive real interest rates. If earnings fail to keep pace with inflation, purchasing power is lost.

When interest rates change, they affect the cost of borrowing money. Increases in interest rates make it more difficult for consumers and businesses to qualify for bank loans. That occurs because loan approvals require that interest payments as a percentage of income remain below specific levels. When fewer loans are approved, business activity declines, economic growth falters, and unemployment tends to increase.

Interest rates in the United States and several other countries have declined in 2001 as a consequence of central bank actions. These actions have been taken in response to slower economic growth. Along with slower growth, corporate profitability has faltered, bankruptcy filings have increased, and unemployment has risen. Interest rate reductions are designed to bolster economic activity by increasing the demand for loans. They also improve business and personal balance sheet performance by lowering interest payments on existing loans.

Because inflationary pressures have subsided in recent months, many business analysts believe that central banks here and abroad can safely continue to lower interest yields without causing real rates to turn negative. There is no guarantee, however, that business and household borrowing will increase in the United States since indebtedness is near record levels already. Balance sheet performance should continue to be helped by lower interest rates and that will foster generally better economic performance than would otherwise be observed both here and abroad.

Historically, inflation and interest rates have varied enormously in response to changing economic conditions. Successful business performance and personal financial management depend upon at least an elementary understanding of the roles played by both inflation and interest rates in an economy. Investment and borrowing decisions will continue to be influenced by changes in these important variables.

Tom Fullerton and Doyle Smith are Associate Professors in the Department of Economics & Finance at the University of Texas at El Paso.

The above article is reprinted here from the December 2001 issue of the Texas Labor Market Review newsletter published monthly by the Labor Market Information Department of the Texas Workforce Commission. For comments or questions regarding this article, please contact the LMI Department at (512) 491-4922 or e-mail at lmi@twc.state.tx.us.