Effects of Increasing Interest Rates on Inflation in USA

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Effects of Increasing Interest Rates on Inflation

Title of the Article: **“**Fed hikes interest rates by 0.75 percentage points for the second consecutive time to fight inflation.”
Source of the Article: https://www.cnbc.com/2022/07/27/fed-decision-july-2022-.html
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Commentary

The article describes the federal reserve's action to increase the bank's interest rates as an intervention measure toward the increasing inflation rates. The federal bank hiked the current interest rates by 0.75% on July 27, 2022, to intervene against increasing inflation rates in the U.S. (Cox, 2022). As a result of high-interest rates, the benchmarked borrowing rates of the feds increased from 2.25% to 2.5%. Therefore, the borrowing and consumption rates are expected to reduce in the U.S. while the savings rates increase. However, the feds expressed their worries about the recession rate and economic growth. A hike in interest rate will mean low investments and negative growth in the U.S. However, slow economic growth for a short period was an opportunity cost the feds were willing to take as long as the inflation rate was slowed.

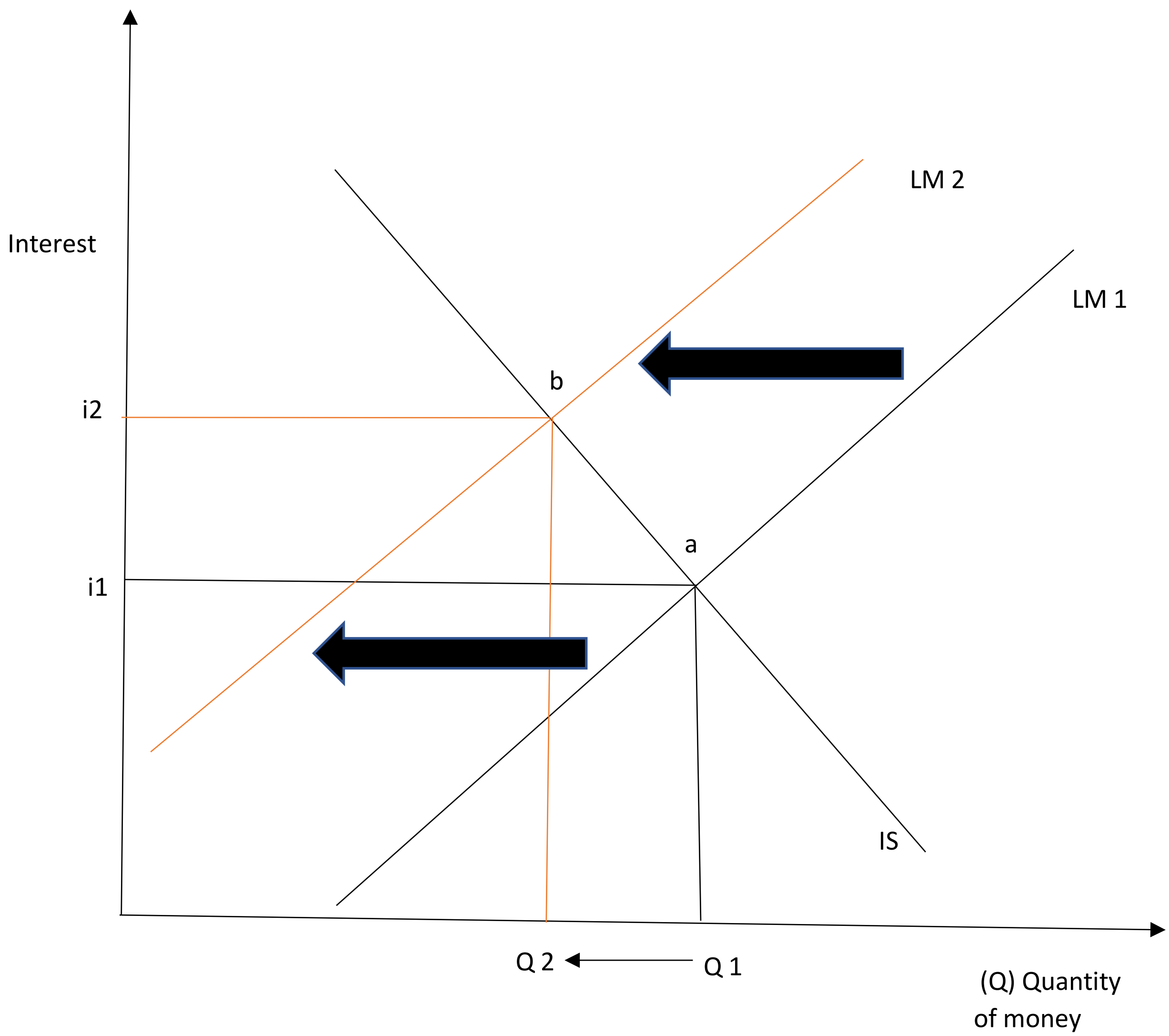

figure 1: Effects of increasing interest rates on the U.S. economy

Figure 1 represents the effects of interest rates on the U.S. economy. It shows the Keynesian view on an economy's interest rates and the quantity of money demanded. According to Keynes, interest rates directly impact the inflation rate. High-interest rates will reduce the amount of money. People will tend to save more and consume less when the interest rates are high. In figure 1, when the interest rates increased from i1 to i2, the equilibrium point moved from point a to b. The equilibrium point moved to the left, signifying an increase in saving and a decrease in investment. Low investment and high savings reduced the amount of money in the economy.

The quantity of supply in the economy reduced from point Q1 to Q2. At equilibrium point "a" the economic demand for liquid money was at Q1, while at equilibrium point "b," the economic demand for liquid money was at Q2. The demand for money reduced as the interest rate increased. Besides, the increase of interest rates from i1 to i2 led to a shift of the liquidity-money curve to the left. The L.M. curve shifted from LM1 to LM2. A shift to the left signifies a decrease in the quantity of money demanded in the economy. Therefore, people in the economy will invest less of their income since high-interest rates encourage savings. A decrease in money demanded will directly lower the inflation rates.

The interest rates have a significant impact on the level of inflation. An increase in the level of interest rates will lower the rates of inflation. Therefore, the U.S. federal reserve to action to increase interest rates will lower the U.S. inflation rates. The article informs us that the fed enacted a 0.75% increase in the interest rate, which increased the benchmarked rates from 2.25% to 2.5%. The intervention will reduce the quantity of money demanded in an economy and the marginal propensity to consume, thus reducing the inflation rate.

Increasing the interest rates was the best fed monetary intervention measure to reduce the inflation rates. High-interest rates would reduce the amount of money y in the economy. It will increase the cost of following and increase the earnings from savings. Therefore, most people will be willing to save more when the interest rates are high. A low money supply will reduce inflation in the economy since the marginal propensity to consume will be low. A low marginal propensity to consume reduces the prices of products. Therefore, companies will reduce the price of products to entice customers to purchase their products. However, an increase in interest rates will negatively impact economic growth, leading to recession. High savings will discourage investments. Most people will be willing to save their income instead of investing. Therefore, the economy will be experiencing slow growth in domestic production.

The intervention will also increase the unemployment rates. If the firms' output falls as a result of high-interest rates, they will require fewer workers. The demand for workers is highly affected by the output level. Low outputs will reduce the number of workers needed in a firm. Lastly, if the feds increase the interest rates by 0.75%, the stock market will also be affected. High-interest rates will make companies reduce their stock price. Organizations will be selling their stock at a low price to convince investors to save less. However, the negative effects of using interest rates as intervention measures to reduce inflation were a risk the feds were willing to take.