# <u>Inflation and Interest Rates</u>

Inflation rate signifies the change in the price of goods and services due to inflation, thus signifying increasing price and increasing demand of various goods whereas interest rate is the rate charged by lenders to borrowers or issuers of debt instrument where an increased interest rate reduces the demand for borrowing and increases demand for investments.

On account of inflation change in the price of goods and services indicates inflation rate. Thus, inflation rate indicates increasing price and demand of various goods. In other hand interest rate is the rate charged by lenders to borrowers or issuers of debt instrument where an increased interest rate reduces the demand for borrowing and increases demand for investments. The interest rate affects inflation and both are closely related. They are generally referred together in macroeconomics.

## <u>Inflation Rate</u>

Inflation is the rate at which the general level of prices for goods and services rise. As for price increase, this leads to falling in the purchasing power of the currency is very much necessary to keep inflation rate within permissible limits for the smooth functioning of an economy.

## <u>Interest Rate</u>

The interest rate is the rate at which the lender is lending funds to the borrower. The interest rate has a vital impact on the economy of the country and has a major impact on stock and other investments.

<u>Factors of deciding interest rate</u>: There are two factors by which interest rate is decided.

1) Availability of Capital: High rate of interest encourages to costly capital
2) Reduce the Bak funds: If the rate of interest is low bank customers will not get sufficient return on their fund which will demotivate customers to keep the amount in bank, as a result, the bank funds will be reduce.

Inflation also depends upon money market if money is cheap, people will get the motivation to get money in the market and as a result, the value of money will decrease. This will increase inflation.

## <u>Relationship Between Inflation and Interest Rate</u>

Relationship between inflation and interest rate may be established as follows.

(a) **Supply and demand**: Quantity Theory of Money determines that supply and demand for money determine inflation. If the money supply increases, as a result, inflation increase and if money supply decreases lead to a decrease in inflation.

(b) **Interest Rate**: This principle is applied to study the relationship between inflation vs interest rate where when the interest rate is high, supply for money is less and hence inflation decrease which means supply is decreased whereas when the interest rate is decreased or low, supply of money will be more and as a result inflation increase that means that demand is increased.

(c) **Control high inflation:** The central bank increases the interest rate. When the interest rate increases, the cost of borrowing rises. This makes borrowing expensive. Hence, borrowing will decrease and the money supply will fall. A fall in the money supply in the market will lead to a decrease in money with people to expense on goods and services. With the supply constant and the demand for goods and services will decrease which leads to falling of the price of goods and services

(d) **Low inflationary situation: The rate** of interest reduces. A decrease in the rate of interest will make borrowing cheaper. Hence, borrowing will increase and the money supply will increase. With a rise in the money supply, people will have more money to spend on goods and services. So, the demand for goods and services will increase and with supply remaining constant this leads to a rise in the price level and that is inflation.

**Thus, they are inversely related to each other and have their own impact. As describe above if an interest rate is high, then inflation and money circulation in a market will be low and if an interest rate is less, then money circulation will be high in a market and hence inflation will increase.**

**Inverse Relationship between Interest Rate and Inflation**

| **Basis** | **When Rate of interest increases** | **When Inflation increases** |
|---|---|---|
| **Effect of Increase** | • inflation decreases<br>• Money Circulations in the market decreases.<br>• Demand for goods & services decrease<br>• Interest rate increase leads to a fall in the price of services and goods | • interest rate decreases<br>• Borrowing became cheap<br>• Demand for goods & services increase<br>• Increase Inflation leads to a rise in the price of service and goods |
| | **When Rate of interest decreases** | **When Inflation decreases** |
| **Effect of Decrease** | • Inflation decreases<br>• Money Circulations in the market increases<br>• Borrowing became cheap<br>• Demand for goods & services increase<br>• Interest rate decrease leads to a rise in the price of services and goods | • Interest rate increase<br>• Money Circulations in the market decreases<br>• Borrowing became expensive<br>• Demand for goods & services decrease |

| | | |
|---|---|---|
| | | • Inflation decrease leads to a fall in the price of services and goods |

**In this way, we can say that the inflation and interest rate are dependent on each other and the relation between them is an inverse relationship where one increases and other decrease and vice versa.**


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