Economic Growth in High Interest Rate period with New Financial Model

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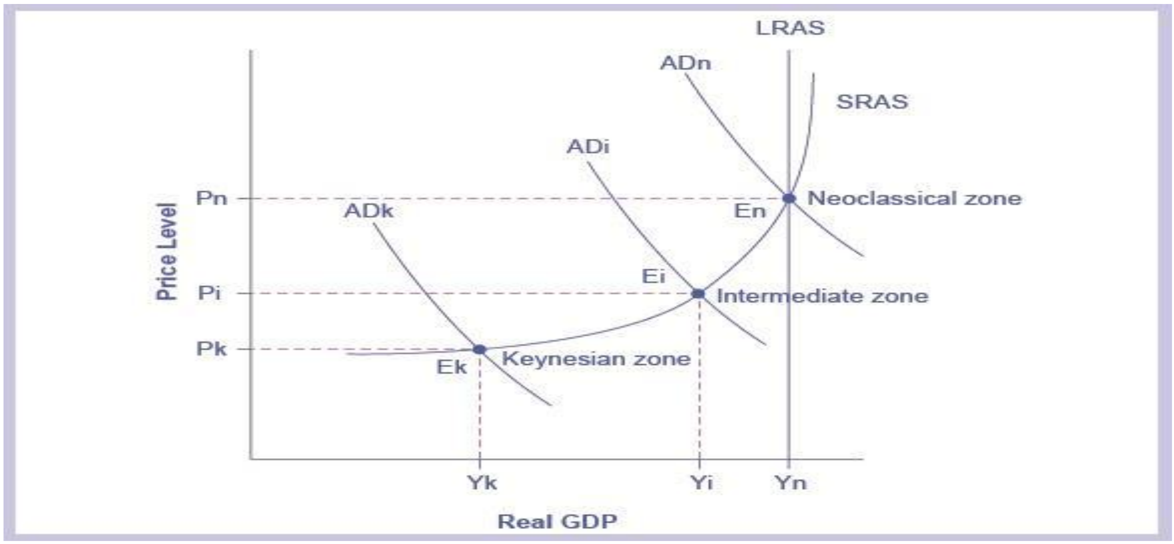
In an economic system, Central banks use interest rates as a tool for the following reasons:

1. For Price Stability: Central banks increase interest rates in response to the inflationary period and decrease it in response to deflation basically to affect the demand in the economic system.
2. To provide financial stability: For example to save bank runs etc.
3. To stabilize exchange rates: to support/depreciate the local currency against others, to handle BOP balance of payment crisis (Currency crisis), to support forex reserves.
4. Others.

Goal of the government in the economic system is to attain an equilibrium level between demand-supply (AD/AS) where there is full employment. In short run, Effective demand can be increased by using various monetary tools like increasing the quantity of money, lowering the interest rates up to a level until the full employment is achieved. Government intervention through fiscal policies also plays important role in short run in bridging the recessionary and inflationary gap as recommended by Keynes.



Above is the Aggregate demand and supply model (image: by OpenStax Link)

When the full employment level is attained (low unemployment level), further increase in demand increases the prices and generates the inflation. Here the central bank increases the interest rates to stem the inflation when inflation rises above central bank's target range and use open market operations (OMOs) to suck out the excess liquidity from economic system.

Effects of High interest rates:

- Moderate economic growth in the economic system.
- Decreases the aggregate demand, so lowers the inflation: due to more saving by individuals because of incentive to save than to spend and less disposable income.
- Increase in borrowing costs: Decrease in investment or private investment due to interest rates being more than the MEC: marginal efficiency of capital.
- Rise in government's borrowing costs.
- Rise in unemployment.

So Generally, Economy experiences a fall in investment and consumption during the high interest rate period.

Let us discuss two important cases in the below table:

Central bank's decision to increase interest rates.		
Case	**Reason**	**Action**
1.	For Price Stability	Action to increase the interest rates is because of demand side inflation which is generated by low interest rates and excess liquidity. **Here the Important thing is that, In this case the central bank is willing to sacrifice the economic growth, so to say moderation in demand and output levels.**
2.	To provide Financial Stability	Action is for the financial and exchange rates stability. **In this case the central bank's intention is not to sacrifice the economic growth. It wants economic growth, wants demand to stay and attain equilibrium with the supply side to attain full employment (low unemployment levels).** **Want the Employment generation in the economy.**
	To stabilize exchange rates& Other reasons.	
	Stag inflation	

Now the question is, **are the authorities in the economic system willing to sacrifice economic growth and employment?** In the first case, authorities are willing to moderate the economic growth due to demand side inflation, but not in the second case. A reason for the first case is demand side inflation which is the result of low interest rates and excess liquidity in the markets.

In the second case, where the interest rate increase is for the financial stability and exchange rate stability, economic growth and employment is equally important.

In the present financial model, increase in interest rate reduces the investment and consumption in the economic system. So moderation or reduction in economic growth and employment is obvious.

This problem can be solved by the New Financial Model, in which specific sectors can be targeted for the growth and employment even in the high interest rate period. I am sharing with you an introductory paper on the New Financial Model. Please download it from the below link:

https://drive.google.com/file/d/1jgHXSvm3fRuhrR-FDNNAJT1KtNWqPu5U/view?usp=sharing

Paper - 2, introducing the New Financial Model will be released soon. I invite the interested organizations/governments to contact for the discussion on the New Financial Model.

Regards

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