Interest Rate: a monetary tool with a lot of problems.

(Responsible for economic cycles, boom-bursts, inflation-deflation, liquidity trap)

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As blood is for body, similarly Money is for the economy. Circulation of both is important.

Money (a medium of exchange/ monetary form of capital) is income on the one side and expenditure/saving on the other. For any economic unit (individuals, companies, and governments) money means cash, saving and investment. For the current & short term needs along with their wish to hold cash: liquidity preference[1], economic units hold the cash, for the expected future expenditure and future desires, they make savings (short term/long term) and to get the return/profit they make investments.

Rate of interest tell us about the cost of capital (money) in an economic system. **In the present economic model, Demand and supply of money determines the rate of interest where Central banks control supply of money and Economic units demand the money for their short term and long term needs. When the supply of money is fixed (from the central bank side/other authority) then the real factors: cash/hoarding (in any form), saving and investment determines the rate of interest.**

Central bank is the whole and sole authority for the monetary side (money) management of economy presently. It manages the supply of money and **uses** interest rate **as a monetary tool to manage demand of money in the economy.** Economic growth and prosperity is the end goal of every economy. Governments (using fiscal policy, other) and Central Banks (using monetary policy) manage the available resources to achieve this goal. Role of the central banks changed from time to time: from War finance during the world wars, development and reconstruction after world wars, full employment, increasing aggregate demand during depression/recessions to price stability after the 1980's stagflation. American central bank Federal Reserve mentions its role that "Federal Reserve Act mandates that the Federal Reserve conduct monetary policy "**so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates**.[2]

Interest rate is the foremost monetary tool which the central banks use to achieve their goals of price stability and employment. It is used to manage the demand side of money: affecting consumption and investment activity in the economy means aggregate demand in the short run. Central Banks decrease the interest rates during low growth periods (recession/economic depression) to increase the aggregate demand (consumption) in the economy and they increase the interest rates during the inflationary period for price stability. They use it for financial stability, exchange rate stability etc. as well.

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[1] The General Theory of Employment, Interest, and Money (1936), John Maynard Keynes. (Chapter 13: The General Theory of the Rate of Interest)

[2] https://www.federalreserve.gov/monetarypolicy/monetary-policy-what-are-its-goals-how-does-it-work.htm

Problems with the use of interest rate as a monetary tool:

1. Choice between economic growth and less inflation: Decrease in interest rates (to increase demand of newly supplied or available money) increases consumption and investment activity in the economy (upward economic cycle, starts boom period, increase inflation) and increase in interest rates (to increase saving/reduce demand of money) reduces the investment and consumption activity: moderate the economic growth (downward economic cycle, boom period reversal, inflation downtrend), it gives choice between economic growth and less inflation. For example during and after the covid-19 period in 2020 and 2021, central banks around the globe decreased the interest rates (along with increasing money supply) to lowest levels to come out of covid-19 recession[3] and boost consumption. Now in 2022 inflation is at a historic high level[4] in most of the countries, central banks (led by the federal reserve) started increasing interest rates to fight inflation and talk of recession started again rather than a safe landing.
2. Failure to work during "Liquidity Trap": When interest rates fall to very low level and fail to increase aggregate demand further, giving no economic growth, the situation is known as "liquidity trap"[5]. Most of the developed world experienced a liquidity trap situation after the 2008 global financial crisis.
3. Responsible for economic cycles: Due to its inverse relation with consumption & investment activity and directly proportional relation with inflation, it is Responsible for economic cycles, boom-bursts, Inflation-deflation period**.**
4. Limitation is that it is not Sector specific: Interest rates increase/decrease affects the economic unit as a whole. Limitation is that it is not sector specific. During the inflationary period all sectors do not generate inflation, only specific sectors generate inflation and only those sectors should be targeted, not the economic unit as a whole and other sectors must grow as usual.
5. Responsible for Foreign Capital inflow/Outflow: Interest rate disparity between countries cause for foreign capital inflow/outflow, thus affects forex reserves of countries.
6. Effects Capital and Commodity Markets: With the variation in the interest rates, money shifts from one asset to other, thus affects capital and commodity markets causing fluctuations in the assets.

As we have discussed the problems of using interest rates as a monetary tool, **we can conclude that central banks should find ways or another monetary tool which can give sustainable economic growth while maintaining price stability** because interest rate as a monetary tool is a choice between economic growth and less inflation, it fails to give economic growth even at very low level during liquidity trap, not sector specific: affects economic unit as a whole (not all sectors generate inflation during inflationary period).

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[3] https://en.wikipedia.org/wiki/COVID-19_recession
[4] https://www.pewresearch.org/fact-tank/2022/06/15/in-the-u-s-and-around-the-world-inflation-is-high-and-getting-higher/
[5] https://en.wikipedia.org/wiki/Liquidity_trap