TA Tomorrow's Affairs

Analysis of today
Assessment of tomorrow

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When The Central Banks left alone against inflation

The most common method that central banks use to fight inflation is "hiking interest rate and shot down the flow of money". However, this method is just like slowing down the bodily functions of a surgery patient. In other words, it is nothing but an anaesthetic given before surgery to put the patient to sleep.

Those who have had surgery before would know that an injection given before general anaesthesia provides a sense of relief, helping the patient have positive thoughts. I know this feeling very well since I have undergone three medical procedures myself. This injection improves patient's morale prior to a surgery that includes risk.

Then, patient is given anaesthetics to avert the agony they would feel during the procedure. Sometimes, anaesthetics may happen to wear off and patient become conscious before surgery ends. Should this happen, patient is put to sleep once again.

Increasing interest rates and decreasing the flow of money is pretty much the same with administering anaesthesia.

When a central bank resorts to this methods, production and consumption begin to slow down, allowing the team that knows where the problem originates from to handle it.

If those who are tasked with treating the disease do not know exactly what causes it, it is unlikely that they would discover it and solve it during the surgery. If the problem is even more complicated than thought, the intervention would take longer or be out on hold so as to restart with new information at a later date.

Side efects

Central banks and government economic teams should discover the real root cause of the problem before using high interest rates to treat high inflation.

After that, they should decide how often and how much they will increase rates and improve dialogue with authorities that have power to intervene in inflation control.

Otherwise, rate hikes won’t do much good in terms of combatting inflation, and the money that keeps growing along with an unstable money multiplier may cause side effects in the future.

> An intervention in interest rates without fully determining the chief cause of inflation will weaken producers' capacity to repay debt

An intervention in interest rates without fully determining the chief cause of inflation will weaken producers' capacity to repay debt while strengthening those who live on money from time deposits or T-Bills and bonds.

As interest rates go up, the amount of money created by banks and financial institutions would exceed the Central Bank's money by several times. In some countries, the amount of bank money held in commercial banks is almost ten times higher greater than the amount of cash money in circulation.

Also, as interest rates increase, deposit and credit multiplier come into play, and central banks that try to handle the problem by promising a cut in flow of money get hit by another problem: "Sterilising the bank money created by high interest rates."

Interest rate as a weapon

In countries that are vulnerable to external shocks, the fact that central banks purchase US dollar or gold to replenish their foreign exchange reserves also causes an increase in the amount of national currency in markets.

Consequently, central banks have to deal with an abundance of money created by their own purchase of foreign currency, which was essentially aiming to shield the economy against high interest rate and external shocks.

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So, before using the interest rate as a weapon to deal with inflation, it is imperative to explore the real reason behind the price increases. Then, effective policies of finance, agriculture, trade and industry must be put into action.

Otherwise, rate hikes alone will not do any good, disinflation process will satisfy neither citizens nor politicians, and eventually, early rate cuts would be introduced due to the growing pressure.

Central banks should also avoid constantly intervening in national currency depreciation. It is the exchange rate themselves that indicate the side effects, and whether the policies in place are effective or not.

Public confidence

Continuous intervention in exchange rates would cause the monetary policy to get disconnected from the reality and it would also lead other authorities, other than central banks, that can or should intervene in inflation, to evade their responsibility.

Under such circumstances, governments would continue to spend excessively, agricultural and animal husbandry policies would suffer, foreign and domestic regulations would increase the cost of living, imports would skyrocket while export activities would become unprofitable.

In order for the growing amount of money under high interest rates does not bring about inflationary effects, governments should take steps to restore public confidence while combating the causes of inflation - Emre Alkin

Frustrated by this predicament, governments would try to tamper with the inflation rate to cover up their failure. Such challenges are experienced in many regions across the world from Latin America to Africa, Middle East to South East Asia.

So, in order for the growing amount of money under high interest rates does not bring about inflationary effects, governments should take steps to restore public confidence while combating the causes of inflation, avoid making statements that anger the public, and most importantly, be sincere in their statements.

Also, we should not be fooled by the fact that credit rating agencies and international financial institutions are applauding the actions of such governments since the ratings that these organisations award are often driven by politics. These organisations cause people to suffer so that a handful of people make outrageous dollar-profits.

Economic policies must look out for the welfare of the people, not create advantage that benefits people belonging to certain groups.