Inflation and Interest Rates Positively Correlated. Low Interest Rates and Slow Wage Growth.

The ideal conditions for a country with a large national debt is high inflation. Inflation is a threat to purchasing power and can drive interest rates and debt service higher. Ideally therefore, what a highly indebted nation requires is high asset price inflation and low consumer price inflation. These are the prevailing conditions in the US where the national debt is over 100% of GDP, interest rates are low, inflation is weak but equity and corporate bond prices are inflated. The conditions seem almost ideal.

Low interest rates can drive inflation lower. Neo Fisherism predicts such a relationship based on the long term inertia of the real interest rate and thus a positive relation between inflation and the nominal interest rate, but a more concrete example, and one that can be extended to include labour markets, is that low interest rates encourage over-investment and encourages over-capacity which is ultimately disinflationary. Raising interest rates could slow investment and reduce excess capacity resulting in greater pricing power or rising inflation. In a low interest rate world, labour is relatively expensive compared with the financing cost of fixed capital. Raising interest rates would render fixed capital relatively more expensive compared with labour, discouraging capital expenditure in favour of employing more labour. It also raises the price of labour in sympathy with the relative increase in cost of capital.