

Two models of inflation and interest rates

I've written about this elsewhere, always part of a wider survey of inflation and rates, but I really need to record this in one place now as it may be important later.

The Gibson Paradox observes that rates and inflation seem to be positively related more than can be explained by lag effects. I therefore went in search of theories that might support a positive relationship between the two and found one such article on the website of the St Louis Fed. The argument goes like this:

If the Fed raises interest rates the nominal rate and the real rate instantaneously rise. However, as the real rate is determined by the productivity and resource endowments of an economy and not monetary policy, the real rate must fade back to the original rate. This happens by inflation rising by the size of the rate hike. Conversely, rate cutting leads to weaker price pressures.

See the St Louis Fed's article on Fisher's view on interest rates here:

<https://www.stlouisfed.org/publications/regional-economist/july-2016/neo-fisherism-a-radical-idea-or-the-most-obvious-solution-to-the-low-inflation-problem>

I also sought a causal microeconomic theory to support the macroeconomic one. There were none I could find and so I formulated one of my own, which, and here is a serious caveat, has not been peer reviewed. The argument goes like this:

Cutting interest rates makes capital and land cheaper relative

to labour. Labour has to compete by suppressing wage growth pressure. Conversely, rising rates makes capital and land more expensive leading to a substitution towards labour, putting pressure on wages to rise.