ExplainSpeaking: What is the link between rising food prices and central banks raising interest rates?

Why are so many central banks, especially the US Fed, raising interest rates sharply, and in the process risking an economic recession, in a bid to control inflation that is caused by higher food and fuel prices? The answer lies in understanding "inflation expectations"

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The fallout from the Ukraine war has led to spike in prices of fuel and food. (File Photo)

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Dear Readers,

Last week the US central bank — routinely called the Fed — announced that it will **raise interest rates by 75 basis points** (or 0.75 percentage points). The Fed is doing this to bring down inflation to its target rate of 2%. At present, inflation in the US is closer to 9%. Most commentators and observers of the US economy point out that every time the Fed has tried to reduce inflation even by as little as 2 or 3 percentage points, it has led to a recession. In other words, if the Fed remains steadfast in its resolve to bring down inflation to 2%, the US will go into a recession.

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Aside 1: What is inflation? How does it affect you?

Inflation is the rate at which prices rise. A 2% inflation implies the general price level in April this year was 2% more than what it was in April last year. A "rising"

April and then 4% in May and 7% in June.

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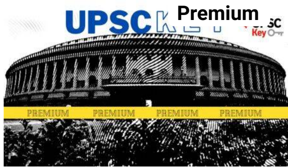

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Frankly, you don't have to imagine. This is exactly what has been happening in most economies of the world lately. Take India, for example, where the inflation rate steadily went up from close to 4% in September last year to almost 8% in April this year.

Why is inflation bad?

Well, apart from making things costly, it essentially erodes the basis on which one makes economic decisions? Should you buy a car today or six months later? Should you lend money? Should you hold back on repaying your loan? Are you sure your income will be enough to pay the bills in six months time? What raise should you ask your boss? Should you invest in starting a new business? So on and so forth.

Aside 2: What is a recession? And how does it affect you?

The technical definition of a recession requires an economy to contract for two consecutive quarters; a quarter is a period of three months.

But Ronald Reagan, who succeeded Jimmy Carter as the US President in 1981 and quite well known for his jokes and humorous statements, had explained it thus:

"Recession is when your neighbor loses his job. Depression is when you lose yours. And recovery is when Jimmy Carter loses his."

bitter pill, the American economy did recover (starting wit… …ıg
But that is a story for another day.

Why is a recession bad? You might be the neighbour who loses his job!

Now, many of you might be wondering why is the Fed raising interest rates when doing so will most probably lead to a recession?

This query holds true for the RBI as well, albeit in India, the economy is not expected to go into recession but will slow down further, which, in turn, will depress incomes, lead to job losses or at the very least worsen the already worrying levels of unemployment in the country.

What makes the Fed's (or the RBI's) decision look even more bizarre is the fact that they openly say that the current inflationary spike is due to supply constraints — in particular, due to rising costs of food and fuel.

For instance, during the June monetary policy review, RBI Governor Shaktikanta Das stated the following while sharply revising the inflation forecast for the current financial year to 6.7% from just 4.5% prediction in April: "75 per cent of the increase in our inflation projection, compared to what we had made in April, is attributed to food inflation…primarily the food inflation spike is linked to external factors, namely, the war in Europe."

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The US Fed Chair Jay Powell, too, stated the same thing: "The surge in prices of crude oil and other commodities that resulted from Russia's invasion of Ukraine is boosting prices for gasoline and food and is creating additional upward pressure on inflation."

So, doesn't the RBI or the Fed know they cannot bring down food and fuel prices by forcing banks to charge a higher interest rate from people wanting to buy a new car or opening a new shop or even taking an education or home loan?

Oddly enough, they know.

down inflation because of “factors that are not under our c

“Again, thinking here of the fallout from the war in Ukraine, as brought a spike in prices of energy, food, fertilizer and industrial chemicals, and also just the supply chains more broadly, which have been larger and longer-lasting than anticipated,” he stated.

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The RBI is also expressing the same helplessness.

In the June Bulletin it states: “There is no doubt that the first impact of a food and fuel price shock to inflation lies outside the realm and remit of the RBI – especially with food and fuel prices constituting 60 per cent of the CPI and the food shock emanating from external sources, in this case, the war in Europe.

So, if the Fed and RBI already know that they can’t reduce food and fuel price-led inflation by raising interest rates and also know that raising interest rates will bring about a recession, or at least hurt growth and employment, then why are all these central banks still trying to do this?

The answer lies in something called “inflation expectations”.

Aside 3: What are inflation expectations and why do they matter?

Simply put, inflation expectations refers to people’s (or households’ expectation of what the inflation rate will be in the future). And they matter because this expectation is what determines people’s economic behaviour.

For instance, what would you do if you expected that the car you want to buy today will cost almost 20% more next year? Especially so, when you expect your income to go up by just 10% in the meantime.

Chances are you will buy the car today when inflation has not yet eroded your purchasing power.

Another fallout of such an expectation — suppose you expect the general price level to rise by 10% over the coming year — is that you might ask your boss for a raise of

nominal increment of 15%.

Alternatively, imagine a scenario when you think prices will go downing the coming year. In such a case, you might postpone buying that car, thinking why waste your money today when you can get the same car for cheaper a year later?

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The net effect of these individual decisions to advance or postpone purchases or ask for higher wages etc. determine the course of a country's economy.

The crucial point here is to understand that people's expectation of inflation often determines what the future inflation will be. For example, if people expect higher inflation and advance their purchases, all of a sudden there will be a spike in demand, far in excess of the supply, thus causing higher inflation.

As such, policymakers try to gauge what is happening to inflation expectations. Gauging these is neither easy nor straightforward. Central banks conduct surveys to assess what is happening to inflation expectations.

So the question changes from: "how raising the interest rate will bring down supply-led inflation?" to "how raising the interest rate will bring down inflation expectations?"

The answer lies in understanding that inflation expectations tend to be "backward looking".

In the June Bulletin, the RBI explains what “backward-looking” means.

“(Households) tend to look at recent food and fuel prices which are salient items in the average consumption basket and they form their opinion about what inflation would be in the future, say three months or a year from now. If households believe that inflation will go up and stay up, they are in effect saying that it is better to prepare for that difficult situation.”

How do they prepare for it?

These expectations start influencing and get built into “price mark-ups, wage negotiations, rents on houses, transportation costs and the prices of services more generally such as personal services like housekeeping, medical and education fees, entertainment and bus, train and auto fares”.

Now, what people buy in their personal capacity is the single biggest engine of GDP growth in India, accounting for almost two-third of India’s GDP in the form of private consumption expenditure. So it is understandable that when inflation becomes entrenched in the people’s psyche it becomes more “persistent and generalised”.

This, in turn, would lead to an adverse outlook on the economy. Business will hold back fresh investment as costs (such as wages) go up. This, in turn, hurts the country’s competitiveness. People pull out money from their savings and put it into

Even so, how does the RBI or the Fed raising interest rates bring down inflation and inflation expectations?

While high interest rates may not affect the supply side inflation, it does dampen the demand for other goods and services. By disincentivizing borrowing (because it is now costlier) a central bank reduces borrowing-led demand. This does two things. One, it reduces inflation by bringing down demand, and two, it gives time — and is expected to do so again this time — for the supply to catch up with the demand.

In short: Ensuring inflation expectations stay "anchored" is the essential goal for monetary policy. Reducing inflation is a way to achieve that goal and raising interest rates is a way to achieve lower inflation.

This is exactly what Fed Chair Powell explained when he was asked if he was trying to induce a recession.

"(No, we are) not trying to induce a recession now. Let's be clear about that. We're trying to achieve 2 percent inflation consistent with a strong labor market," he replied.

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Chair Powell explained that as things stand, despite high inflation right now, the median projection for inflation (in the US) is 5.2% in 2022 and it is expected to fall to 2.6% next year and to 2.2 percent in 2024.

In other words, as things stand, inflation expectations (in the US) are still in place over the medium-term.

"I think if you look across that broad range of data, what you see is that expectations are still in the place, very much in the place, where short-term inflation is going to be high, but comes down sharply over the next couple of years. And that's really where inflation expectations are and also, as you get away from this episode, they get back down close to 2 percent. And so, this is really very important to us that that remain the case," said Chair Powell.