

What is the real interest rate?

When conjecturing the direction of central bank policy rate, we all know that inflation is important as they have a mandate to target this variable. The question then arises as to when should central banks draw the line and pause with rate changes. In this context the concept of real interest rates is spoken of where markets try and guess the real interest rate that central banks may be having at the back of the mind. Here, we look at real policy rates across different countries to gauge if there is any pattern that can be observed.

The pandemic had changed the way in which central banks looked at inflation as the policy rate was lowered to the least possible level including zero to ensure that everything was done to preserve growth which turned negative across the globe. But with things getting normal, rates have moved upwards as inflation has risen partly due to the economic recovery which led to increase in demand across all commodities and services as well as the Ukraine war which has caused significant disruptions.

The situation today is still rather unusual because inflation is very high in most countries and hence central bank policy rates are quite misaligned with inflation. This also means that it is not conceivable for central banks to provide a positive return on their policy rate as inflation is much higher than their target rate which has generally been in the region of 2%. Therefore it is believed that the central banks will raise policy rates to a certain level and keep a watch on the inflation rate which is expected to come down over time due to cumulative policy rate action.

India has been different because we have been targeting a higher inflation rate of 4% with a band of 2% which means that even a number just less than 6% may not be a concern. Besides while inflation had touched 7% we have not had double digit numbers for several years. The repo rate has already reached 6.25% and is expected to be raised once more to 6.5% in February. Assuming that the rate cycle ends as inflation is likely to move downwards, the real interest rate could then be assessed.

The table below gives the policy rate as well as inflation rates for various countries along with the real policy rate (in our case the real repo rate).

Some observations here are:

- In case of India we are in the positive zone when it comes to real repo rate.
- Asian countries have tended to have positive real rates as seen in case of China, Saudi Arabia, while Brazil and Mexico in Latin America are in a similar state.
- The euro area, UK and USA are at the other level where inflation is just too high real rates are negative and will remain so until inflation comes down as central banks are unlikely to hike their rates beyond another 50-100 bps in the coming months and would wait for the rate hikes

to have their impact on inflation. USA has witnessed a downward movement in inflation which makes it possible to pause after a while. For Euro area inflation is still at 10% which offers scope for further aggression. The same holds for UK.

Table: Real central bank policy rates (%)

Country	Central bank rate (%)	Latest Inflation (%)	Real Central Bank rate %
Argentina	75.00	92.40	-17.40
Australia	3.10	7.30	-4.20
Brazil	13.75	5.90	7.85
Canada	4.25	6.90	-2.65
China	3.65	1.60	2.05
Euro Area	2.50	10.00	-7.50
France	2.50	6.20	-3.70
Germany	2.50	10.00	-7.50
India	6.25	5.88	0.37
Indonesia	5.25	5.42	-0.17
Italy	2.50	11.80	-9.30
Japan	-0.10	3.70	-3.80
Mexico	10.50	7.80	2.70
Netherlands	2.50	9.90	-7.40
Russia	7.50	12.00	-4.50
Saudi Arabia	5.00	2.90	2.10
Singapore	3.13	6.70	-3.57
South Africa	7.00	7.40	-0.40
South Korea	3.25	5.00	-1.75
Spain	2.50	6.80	-4.30
Switzerland	1.00	3.00	-2.00
Turkey	9.00	84.39	-75.39
United Kingdom	3.50	10.70	-7.20
United States	4.50	7.10	-2.60

Source: Tradingeconomics, December 16, 2022

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