Challenges with Interest Rate Structure

What is the issue?

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Despite the lower inflation rates, interest rates have not reduced significantly in India, warranting a re-look at its structure.

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What does the inflation data reveal?

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- The multi-month low CPI and wholesale inflation in December pose an interesting challenge for policymakers and the central bank.
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- Inflation in Consumer Price Index (CPI), at 2.19% in December, is at an 18-month low, while the WPI, at 3.8%, is at an eight-month low.
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- The RBI has maintained a CPI projection of 4.4-4.8% for the second half of fiscal 2019.
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- Even in the October policy announcement, the bank projected 3.8-4.5% retail inflation in the second half with upside risk.
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- It has even changed its policy stance to “calibrated tightening” from “neutral”.
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- Neutral stance indicates a marginal increase in repo rate which is proportionately lesser to the inflation projections, while calibrated tightening indicates that there will not be a rate cut in the near future.
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- However, the CPI number is way below projections made by RBI during its last few monetary policy pronouncements.
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- Thus, the MPC and the RBI may well want to reassess the robustness of their

inflation projection mechanism in light of the data coming in.
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- Also, factory output growth was a low 0.5% in November with manufacturing showing a contraction.
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- Given the weak economic data, RBI may look at a rate cut in its next monetary policy committee meeting.
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What are the challenges?

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- The inflation data have also been challenging for policymakers, wherein different components show divergent trends.
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- While headline CPI inflation is trending lower at 2.2%, core inflation (non-food, non-fuel inflation) is still remains at 6%.
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- Also, there is a divergence between core rural and urban inflation, wherein the former stays at 6.34% while the latter stays at 5.26% in December.
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- This rise in core rural inflation is attributed to the high rural health and education index numbers.
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- Thus, divergences and volatility in different sub-groupsof inflation data serve as a major challenge in inflation assessment and projection.
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- This gives rise to a broader question that whether the interest rate structure is lagging behind the big structural change in inflation in the last few years.
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Is there a need for change in the interest rate structure?

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- Nominal interest rate refers to the interest rate before taking inflation into account, while a real interest rate is the interest rate that the lender or investor receivesafter inflation is factored in.
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- For example, if a bond provides a 6% nominal yield and the inflation rate is 4%, then the lenders can benefit from the real rate of interest of only 2%.

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- Thus, Nominal interest rate - Inflation = Real interest rate.
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- Nominal interest rates will exceed real rates when the inflation rate is a positive number (as it usually is).
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- But real rates can also exceed nominal rates during deflation periods.
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- In India, headline CPI inflation has already moderated from around 10% in 2012-13 to 3.6% in 2017-18 and 3.7% in April-December this fiscal.
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- Yet the nominal interest rate structure is maintained at a higher level and has not changed significantly.
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- Thus, since the nominal interest rate is exceeding the inflation rate, high real interest rates are prevailing now.
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- Thus, prominent policymakershave called for the RBI to take a re-look at the interest rate structure.
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Source: The Hindu

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