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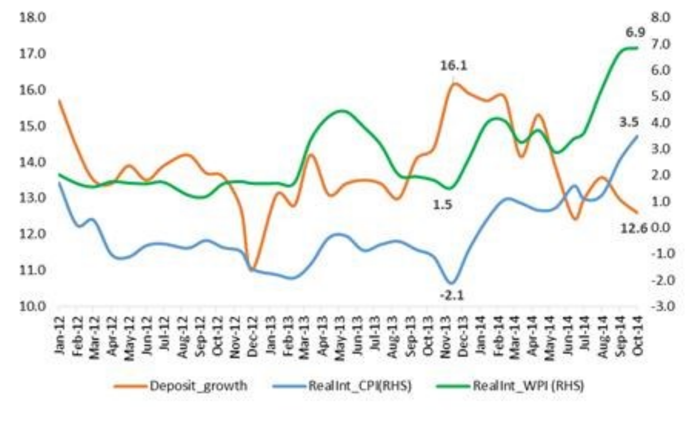
An Update on Real Interest Rate

In recent times there has been a significant decline in savings. There has been several reasons for such a decline, the notable being the fact that real interest rates have stayed negative for 21 consecutive months. We however, believe, negative interest rates may not be the only factor in such. Interestingly, in economic literature, an increase in real interest rates is postulated to have an ambiguous effect on savings because of a positive substitution effect towards future consumption and a negative income effect due to increased real returns on saved wealth. In the Indian context, studies show that the substitution effect of real interest rate is more than the income effect leading to overall negative impact of higher interest rates to savings rates. However, the actual coefficients are relatively small (ranging from 0.1 to 0.3), suggesting a change of as much as 3% to 10% in real deposit rates will be needed to change savings rate by 1%. We however believe if RBI leaves the rates unchanged, the real rates would reach as high as 4.6% during Nov-14 by taking CPI as proxy and 8.1% if WPI is taken as proxy. This will be significantly higher than the desired real interest rate at 2%. We however believe that the launch of Pradhan Manrti Jan Dhan Yojana (PMJDY) will lead to better access to banking and will promote private savings in a developing country like India. This apart, an increase in optional contributions to the PPF will still encourage Indians to save more in order to meet their expected retirement benefits. This will be also enabled by the significant increase in life expectancy in India in recent years (life expectancy at retirement is now 82 years). Indian households therefore necessarily have a stronger bequest motive so that a positive effect of anticipated retirement benefits can be expected. All in all, an increase in financial savings may be expected because of the recent Government changes.

- Due to falling inflation and higher nominal interest rate structure combined with the central bank credible monetary policy measures for anchoring inflation expectations led to positive real rates. The real interest rate is calculated by taking into account term deposit rate (>1 Year) and CPI (combined-All India) inflation rate. The real interest rate is positive since Jan'14, after remaining negative for 21-months. Interestingly, the deposit growth is falling from the peak of 17.0% in Dec'13 to 12.6% in Oct'14, despite an increase in real interest rate from (-) 0.8% to 3.5% during that period (3.5% is estimated with CPI inflation of 5.6% in Oct'14; actual real interest rate for Sep'14 is 2.6%).

Graph 1: Real Interest Rates and Deposits



Source: RBI, MOSPI, SBI Research

- If RBI leaves the rates unchanged, the real rates would reach as high as 4.6% during Nov'14 by taking CPI as proxy and 8.1% if WPI is taken as proxy. Thus we will be in an enviable situation, where real interest rates will be higher than nominal interest rates for most banks in the deposit category of less than 1 year. This is way above the 0.5% (CPI) and 1.5% (WPI) real rate prevailing on a cross cyclical basis in India.

- Our take on the expected real interest rate is that it should be ideally around 2% (repo rate at 8% and desired CPI at 6%), if we go by RBI assumptions of 6% monetary targeting. However, we must add that the equilibrium real rate is not constant throughout the cycle so it should be lower than 2% today-especially since firms and consumers face different real rates currently.
- In economic literature, an increase in real interest rates is postulated to have an ambiguous effect on savings because of a positive substitution effect towards future consumption and a negative income effect due to increased real returns on saved wealth. Empirically, some economists (e.g., Giovannini, 1985) have found savings to be insignificantly related to real interest rates while other (e.g., Fry, 1995) has found a small but positive interest rate elasticity of savings. In the Indian context, studies show that the substitution effect of real interest rate is more than the income effect leading to overall negative impact of higher interest rates to savings rates. However, the actual coefficients are relatively small (ranging from 0.1 to 0.3), suggesting a change of as much as 3% to 10% in real deposit rates will be needed to change savings rate by 1%.

Table 1: Banks Term Deposit Rates (1 to 3yrs)

Bank	Rate (%)
Axis Bank	9.00
Bank of Baroda	9.05
Bank of India	9.05
Canara Bank	9.05
Central Bank	9.05
Corporation Bank	9.00
HDFC	9.00
ICICI	9.00
IDBI	9.05
Indian Overseas Bank	9.00
Oriental Bank of Commerce	9.00
Punjab National Bank	9.00
State Bank of India	**8.75**
Union Bank	9.05
Average	**9.00**

Source: SBI Research