



MARKETS IN MOTION

developments that matter in financial markets

Interest Rates: To Raise or Not to Raise?

“Reverting to the high growth trajectory at the earliest remains the key policy challenge in the near to medium term. The sustained expansionary fiscal and monetary policy stances, however, entail the risk of aiding inflationary pressures in the near term and constraining the growth process in the medium run. Timely exit from the current policy stance, thus, would be critical, given the emerging signs of inflationary pressures.”

Dr D Subbarao, Governor, Reserve Bank of India

The objectives of the monetary policy of central banks all over the world have been to maintain price stability and to help accelerate the rate of economic growth. The policy rates of central banks have emerged as an important indicator for signalling the monetary policy and guiding the market interest rates to the desired trajectory.

Interest rates fell significantly across developed and developing markets owing to the slowdown of the world economy. In the last two years, interests were brought down to historic lows to spur the demand and stimulate the economies.

However, with the spectre of inflation looming large, there is again thinking on hardening of interest rates as uncontrolled inflation could be detrimental to the economic growth.

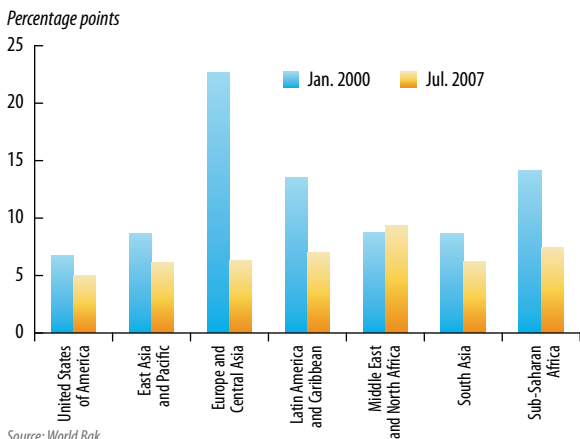
The change in the official interest rates directly affects money market interest rates and indirectly affects lending and deposit rates, which are set by banks to their customers.

Monetary policy can also guide economic agents' expectations of future inflation and thus influence price developments. A central bank with a high degree of credibility firmly anchors expectations of price stability. In this case, economic agents do not have to increase their prices for fear of higher inflation or reduce them for fear of deflation.

Current Status of the Economy

Indian economy is poised for a robust growth on the back of a good industrial and services sector performance in the last quarter of FY10. While the wholesale price index (WPI) inflation rose from around 1 percent in October 2009 to 9.9 percent in February 2010, consumer price index (CPI) inflation has been running in double digits on the back of high food prices. These developments are occurring in an environment of abundant liquidity in the system.

Interest Rates of Developing Countries Fell Substantially During the Boom Period



Year	GDP Growth	Gross Fiscal Deficit (% of GDP)	Inflation (52-week Average)* Feb-10***
2009-10	7.2%	6.5%	9.9% (WPI)*** 11.4% (CPI)***
2008-09	6.7%	5.9%	8.4% (WPI)* 9.1% (CPI)*
2007-08	9.2%	2.6%	4.75% (WPI)* 6.2% (CPI)*

Source: Economic Survey 2010, Ministry of Finance, GOI

It has been observed that every phase of high inflation coincides with low economic growth in India. For example, inflation was 13.7 percent in FY1992 while the economic growth was 1.3 percent. In FY2001, the economic growth was 4.4 percent when inflation was at 7.7 percent.

On the contrary, moderate inflation leads to high economic growth as is evidenced by the fact that during FY03 to FY08, the average economic growth was around 8.5 percent (except in FY05 when the monsoon failed) when the average inflation was 4.5 percent during the period. The empirical evidence suggests that price stability is the key to economic growth.

The current concerns on inflation arise from several and simultaneous developments. Though countries began to recover from slowdown, vulnerabilities in the global financial system continue to persist. Sovereign debt positions of some euro zone countries have become precarious. Governments in the developed world have not yet come out with specific programmes to exit from the stimulus packages. In this context, it would be a real challenge to tame inflation without affecting growth.

The current interest rates of the central banks of major economies are furnished below:

Central Bank	Current Rates
Federal Reserve System	0.25%
European Central Bank	1.00%
Bank of England	0.50%
Bank of Canada	0.25%
Peoples Bank of China	5.31%
Bank of Japan	0.10%
Reserve Bank of Australia	4.25% (w.e.f. 6-4-10)
Reserve Bank of India	5.00% (w.e.f. 19-3-10)

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