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Real interest rate

Technical box extracted from:

Inflation Report no.4, November 2012 [1]

The interest rate is one of the main monetary policy instruments through which the National Bank of Moldova influences the evolution of prices. The economic situation may be presented more objectively through the use of real indicators. In this context, it should be mentioned that the real interest rate is a very important indicator for the promotion of the monetary policy, which accurately describes the monetary policy promoted in a certain period. The monetary policy may be of three types: expansionary, neutral and restrictive.

The real interest rate is approximately the nominal interest rate minus the inflation rate. For example, if the nominal interest rate is of 5.0 percent and the inflation rate is of 4.0 percent, then the real interest rate is of 1.0 percent.

The relationship between real and nominal interest rates and the inflation rate is presented in the ***Fisher equation***. Expressed as the linear approximation, it can be presented as follows:

$i = r + \pi^e$

where,

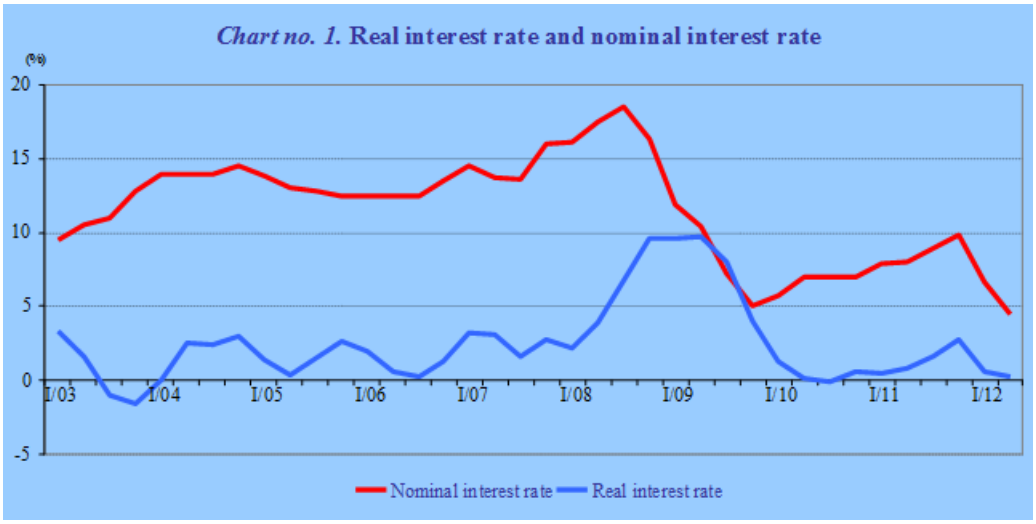
i – nominal interest rate;
r – real interest rate;
π^e – expected inflation rate.

Thus, the formula for calculating the real interest rate can be rewritten as follows:

$r = i - \pi^e$

The nominal interest rate may have only positive values, but the real interest rate may have both positive and negative values. The real interest rate indicates a negative value when the inflation rate exceeds the nominal interest rate.

At the end of 2011 (Chart no.1), the average quarterly nominal rate of monetary policy was around 10.0 percent, while the real interest rate was close to 3.0 percent. According to the chart shown below, the monetary policy during the last quarter of 2011 was insignificantly restrictive, while in the first quarter of 2012 the monetary policy had expansionary features, following the decisions to decrease the monetary policy rate.



Tag-uri

nominale rate [2]

real rate [3]

the formula for calculating [4]

average value [5]

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Legături conexe:

[1] https://www.bnm.md/files/nov_2012_en_1.pdf [2] https://www.bnm.md/ro/search?hashtags[0]=nominale rate [3] https://www.bnm.md/ro/search?hashtags[0]=real rate [4] https://www.bnm.md/ro/search?hashtags[0]=the formula for calculating [5] https://www.bnm.md/ro/search?hashtags[0]=average value