

Class: FY MSc

Subject : Financial Mathematics

Chapter: Unit 2 Chapter 1

Chapter Name: Real and Monetary Interest rates

Today's Agenda

1. Inflation
 1. Extreme inflation Hyperinflation
 2. Effects of Inflation
2. Monetary and Real Interest Rates
 1. Example
 2. Relationship between Monetary and Real rates
3. Deflation

Answer this!



If an individual invests Rs. 1 lac at the start of the year which gets accumulated at 15% effective rate of interest.

Tell me the accumulated value after 1 year?

Also, will the value of the accumulated amount be the same as the value it accumulated to?

1 Inflation



- Refers to the rise in the prices of goods and services
- Inflation measures the average price change in a basket of commodities and services over time.
- Indicates loss of purchasing power per monetary unit.
- Purchasing power is the amount of goods that your money can buy. When inflation occurs you can buy less goods with the same amount of money. i.e. it takes more monetary units (now) to buy what you could buy for lesser monetary units a period of time ago.
- Important indicator of a country's economic performance.



1 Inflation

- Measure of Inflation – Consumer Price Index (CPI), quoted on annual basis
- The change in CPI measure the effective annual rate of change in the cost of a specified “basket” of consumer goods.
- Alternative measures: Wholesale Price Index (WPI) and sector wise in the economy.
- Decreasing CPI – Deflation

1.1 Extreme Inflation/ Hyperinflation

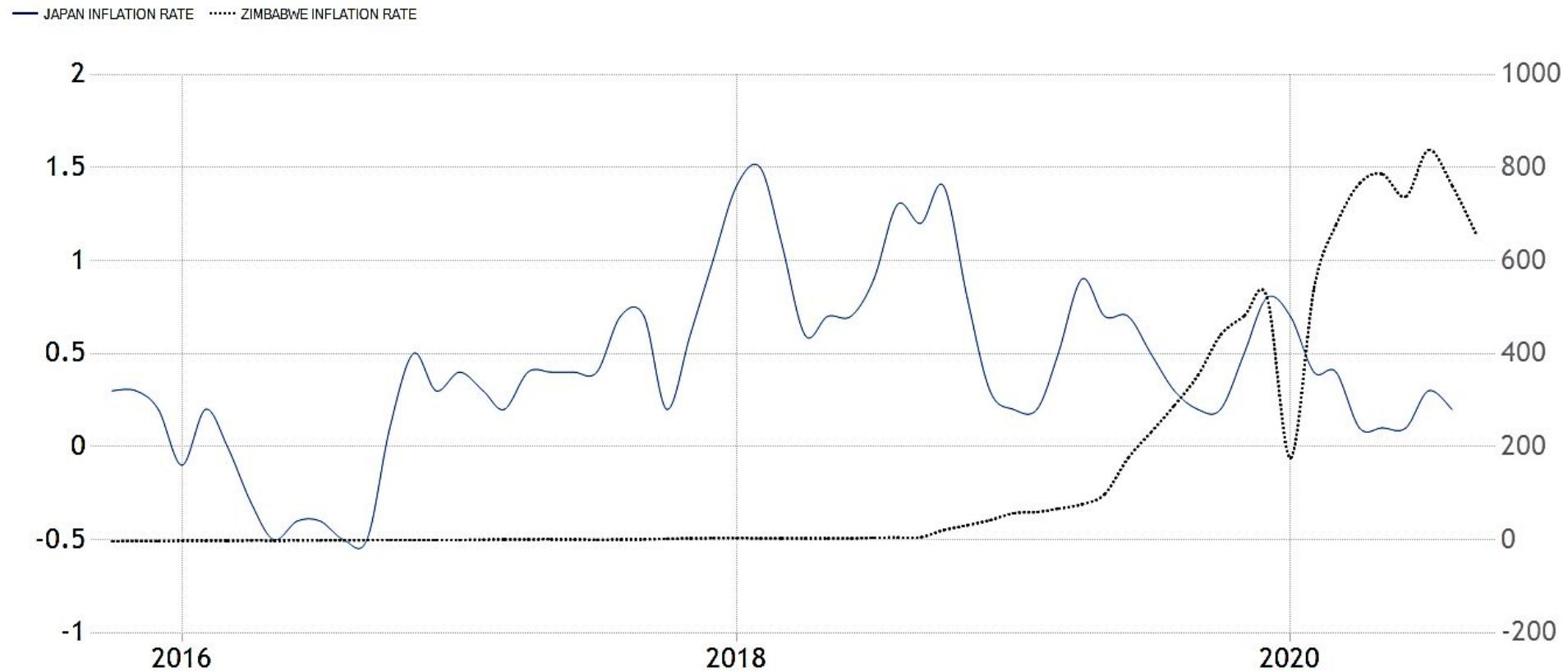
Hungary – 1946 (Post world war II)

- Caused because of the reparations that were paid for the war
- Estimated daily inflation rate – 200%
- Monthly inflation rate – 41.9 quadrillion% for July 1946 i.e. price doubling every 15.3 hours

Zimbabwe – 2004 to 2009 (Congo War)

- Printed money to pay for war in the Congo
- Droughts and farm confiscation restricted the supply of food and other locally produced goods
- Estimated daily inflation rate – 98%
- Price doubling every 24 hours
- Ended when the country changed its currency to the U.S. dollar

1.1 Inflation comparison (Japan vs Zimbabwe)



SOURCE: TRADINGECONOMICS.COM

1.1 Extreme Inflation/ Hyperinflation

Venezuela – Currently

- Prices rose 41% in 2013, and by 2018 inflation was at 65,000% (In 2017, govt. increased money supply by 14%)
- A new cryptocurrency, the "petro," is promoted because the bolivar lost almost all its value against the U.S. dollar
- In response, people began using eggs as currency. A carton of eggs was worth 250,000 bolivars compared to 6,740 bolivars in January 2017
- Unemployment rose to over 20%
- The annual inflation rate for consumer prices was at 15,000% percent in early 2020
- Currently, the only country to suffer from hyperinflation

How did Venezuela create such a mess?

Former President Hugo Chávez had instituted price controls for food and medicine. But mandated prices were so low it forced domestic companies out of business. In response, the government paid for imports.

In 2014, oil prices plummeted, eroding revenues to the government-owned oil companies. When the government ran out of cash, it started printing more.

1.2 Effects of Inflation

- Investors are concerned with the level of inflation in the country
- High rate of inflation has the effect of rapidly reducing the value of currency as time goes on
- When inflation is expected, investors will require higher interest rates because they are interested in actual growth in their buying power, not just the growth in the monetary terms that they possess
- Common understanding: Interest rates reflect predicted inflation rather than the actual inflation
- In the above situations and situations similar to these, money interest rates cannot be the ideal variable for measurement of investment growth as they do not account for inflation. Thus it is important to consider real interest rates which take into account the inflation in the economy

2

Monetary Interest rates vs Real Interest rates

Monetary Interest Rate

- Monetary interest rate is the interest rate we have been considering up till now.
- Suppose Rs.100 invested at time 0 for 10 years, grows at the rate of 7% per annum interest.
- In the above case, we have a money interest rate of 7% p.a.
- If we are given the information on the initial investment of 1 in the specified currency, the period of the investment, and the cash amount of money accumulated, then the underlying interest rate is termed a “money rate of interest”

Real Interest Rate

- The Real rate of Interest refers to the inflation-adjusted rate of return. A real interest rate is adjusted to remove the effects of inflation and gives the real rate of a bond or loan.
- The real interest rate gives lenders and investors an idea of the real rate they receive after factoring in inflation. This also gives them a better idea of the rate at which their purchasing power increases or decreases

2.1 Example

A Vadapav costs Rs. 10 as at 1/1/16 and Rs. 12 as at 1/1/17.

The annual rate of inflation, j is: $1 + j = \frac{12}{10} = 1.2$. i.e. $j = 20\%$.

Suppose you had a sum of money, say Rs. 120. It would buy 12 vadapavs on 1/1/16, but only 10 vadapavs on 1/1/17.

Since Rs. 120 can only buy 10 vadapavs on 1/1/17, it is equivalent to Rs. 100 (10 Vadapavs x Rs.10) at the start of the year.

$$\text{i.e. } \frac{120}{1+j} = \frac{120}{1.2} = 100$$

2.2 Relationship between Real & Monetary rates

- Simple and commonly used measure of the real rate of interest is: $i-j$, where i is the annual rate of interest and j is the annual inflation rate
- The real growth of an investment or real growth in purchasing power, $i-j$ is not theoretically correct.

2.2 Example



Suraj invests Rs. 1000 for one year at effective annual rate 15.5%. At the time of investment, cost of certain item is Rs 1. One year later, when interest is paid and principal is returned to Suraj, the cost of item has become Rs. 1.1. What is the annual growth rate in Suraj's purchasing power with respect to the consumer item?

2.2 Relationship between Real & Monetary rates

- Consider an investment of one unit of principal at time 0 that produces an accumulated value of $A(0,t)$ at the rate of interest i .
- Suppose there is inflation in the economy so that the cash $A(0,t)$ is effectively worth only $A^*(0,t)$ after allowing for inflation, where $A^*(0,t) < A(0,t)$.
- In this case, the rate of interest at which the original sum of 1 would have to be accumulated to produce the sum A^* is lower than the money rate of interest.
- The sum $A^*(0,t)$ is referred to as the real amount accumulated, and the underlying interest rate, reduced for the effects of inflation, is termed a “real rate of interest”.
- With an annual rate of interest i and an annual inflation rate j , the real rate of interest r is given by :

$$1 + r = \frac{1+i}{1+j} . \text{ Thus } r = \frac{i-j}{1+j}$$

2.2 The other way

2.2 Example



In an economy, at the start of the year the cost of a certain consumer item was 1.05. Now today the same consumer item costs 1.10. What will be the inflation rate for the year?

Under the same scenario, Dhruv plans to make an investment of Rs.10000 at time 0 for a quoted rate of 10.5% for a period of 1 year. Find the real rate of return and the real accumulated value.

3 Deflation

- Where the inflation rate is negative, termed “deflation”, the theory still applies and $A^*(0,t) > A(0,t)$, giving rise to the conclusion that the real rate of interest in such circumstances would be higher than the money rate of interest.
- As might be expected, where there is no inflation $A^*(0,t) = A(0,t)$, and the real and money rates of interest are the same.
- These scenarios occur very rarely in practice.

Recap

- Inflation refers to the rise in the prices of goods and services.
- If we are given the information on the initial investment of 1 in the specified currency, the period of the investment, and the cash amount of money accumulated, then the underlying interest rate is termed a “money rate of interest”.
- The Real rate of Interest refers to the inflation-adjusted rate of return. A real interest rate is adjusted to remove the effects of inflation and gives the real rate of a bond or loan.
- With an annual rate of interest i and an annual inflation rate j , the real rate of interest r is given by :
$$1 + r = \frac{1+i}{1+j} . \text{ Thus } r = \frac{i-j}{1+j}$$
- Where the inflation rate is negative, termed “deflation”.