

7 April 2000

ENGLISH ONLY

STATISTICAL COMMISSION and
ECONOMIC COMMISSION FOR EUROPE

CONFERENCE OF EUROPEAN STATISTICIANS

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT (OECD)

COMMISSION OF THE EUROPEAN
COMMUNITIES (EUROSTAT)

Joint ECE/Eurostat/OECD
Meeting on National Accounts
(Geneva, 26-28 April 2000)

A NOTE ON REAL INTEREST AND GOVERNMENT DEFICIT

Working paper submitted by the Central Bureau of Statistics, Israel*

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1. This note shows that using nominal interest flows distorts estimates of government's saving and net lending/ borrowing, even when inflation is relatively low.

Section 1: Interest flows in 93SNA

2. Paragraphs 7.109 to 7.111 in 93SNA discuss nominal and real interest. It distinguishes two components in actual payments of nominal interest:

- a) "A payment equal to the loss of purchasing power of the monetary value of the principal during the accounting period;
- b) The balance remaining that represents the real interest accruing to the creditor".

3. From a conceptual point of view it is clear that real interest should be applied even if inflation is relatively low. Nevertheless, the SNA recognizes that "in practice...the interest recorded is always the amount of nominal interest receivable or payable" (par. 7.111). No recommendation is explicitly made by the SNA on changing this practice.

4. The difference between nominal and real interest payments may be significant even at relatively low levels of inflation and rates of interest, if the values of loans, deposits and other financial instruments bearing interest as returns, represent a high percentage of GDP.

5. On the other hand, in many cases the use of nominal interest can not be justified on the basis of practical difficulties. When nominal interest and interest on index-linked loans and deposits in the national currency coexist in the market, it is not possible to add these two types of interest directly. It is necessary to convert to nominal the interest charged on price-indexed financial assets or, alternatively, to convert the nominal interest flows to real ones. It follows that problems may exist in practice when registering all interest flows on a nominal basis or, alternatively, all of them on a real basis.

6. In order not to distort aggregates such as national income, disposable income and savings, nominal interest must be divided into two components and only Real interest should be included in the primary income.

Section 2: Nominal versus real interest flows in general government accounts

7. Israel uses real interest rates in its national accounts, because most assets/liabilities of financial instruments bearing interest are index linked. Indexation was introduced when the economy experienced very high rates of inflation, especially during the first half of the 80's. Since then, inflation as measured by CPI has dropped in 1999 to 5.2 percent. Table 1 shows the impact of using nominal or real interest flows on general government savings and net lending.

Table 1. Real, nominal interest and general government's accounts balancing items

	Balance of Primary income	Saving (net)	Net lending/ net borrowing

Percent of GDP			
1998			
Real interest	13.6	-2.2	-3.5
Nominal interest	9.3	-6.5	-7.8
1999			
Real interest	12.8	-3.6	-4.7
Nominal interest	9.1	-7.3	-8.4

8. The table shows that the differences in the values of the balancing items are very significant and therefore the conceptually correct treatment should be applied. Applying what is called the "nominal" rate of interest leads to wrong conclusions about government's saving and net lending.

9. Real interest in this note differs from the "real interest approach" because the payment that "equals the loss of the purchasing power of the monetary value of the principal" is not included as a capital transfer. It also differs from the prime interest approach

because when there is a negative real interest it is not considered as a zero interest and a holding loss.
