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PRESS RELEASE

Causes and implications of the low level of the risk-free interest rate
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In most advanced economies, risk-free interest rates - i.e. rates with minimum credit risk - have fallen to historically low levels over the recent period. These interest rates are particularly important because they form the basis for determining other interest rates, and therefore influence financing conditions throughout the economy.

This article considers the causes and implications of such an environment. The first section looks at the current level of risk-free interest rates in a historical perspective. The second section presents an analytical framework of interest rate determinants, while the third section uses that framework to study the main factors behind the movement in risk-free interest rates in the United States and in the euro area since 1990. The fourth section discusses how an accommodating monetary policy stance contributes to macroeconomic stability – and therefore to price stability – but also examines the associated risks for financial stability. More specifically, the fifth section illustrates the challenges which persistently low interest rates present for the insurance sector and for pension funds, and the risks of a sudden rise in interest rates.

In recent months, nominal interest rates have reached a historic low, while real interest rates have fallen to minimum peacetime levels. These developments are due to a number of different factors. First, the equilibrium interest rate has displayed a downward trend since the early 2000s, a trend which became slightly more marked during the crisis. This largely reflects the reduction in potential growth and the downward revision of long-term growth expectations. While that phenomenon is largely exogenous to monetary policy, the latter is another key factor behind the decline in interest rates. The increased transparency and credibility of central banks since the 1990s has in fact led to a reduction in the inflation component of interest rates, while the crisis conditions prompted the adoption of particularly accommodating monetary policies. Moreover, a number of central banks tried to bring interest rates down via unconventional measures, primarily forward guidance and asset purchase programmes. Finally, certain factors such as excess savings at global level, increased risk aversion due to financial tensions, and financial regulation generated increased demand for the most secure assets and therefore helped to bring about the decline in interest rates.

By keeping down financing costs in the economy, a low interest rate today offers the best chance of a revival in economic activity, and therefore contributes to macroeconomic and financial stability. In that sense, it is the best guarantee that interest rates will climb back up in the future. However, a low interest rate situation also presents risks to financial stability. For instance, such an environment may have an adverse effect on economic productivity, reduce the incentives for balance sheet consolidation, or encourage risk-taking on the part of investors. Some players, such as insurance companies and pension funds, might be particularly tempted to increase their risk tolerance in order to take advantage of higher returns. These secondary effects accompanying low interest rates necessitate close surveillance by the prudential authorities, and possibly the adoption of targeted measures.

A sudden steep rise in interest rates could also be detrimental to financial stability. On that subject, the recent bond market volatility, associated with the market participants' view that the US Federal Reserve could start to reduce its purchases of long-term securities, demonstrates that it is absolutely vital for central banks to maintain rigorous, effective communication, not just as a general rule, but especially when it comes to ending the currently very accommodating policies.

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