ESRB
European Systemic Risk Board
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Low interest rates and implications for financial stability - A discussion

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Discussion based on Joint ATC/ASC/FSC Task Force on
MACRO-PRUDENTIAL ISSUES AND STRUCTURAL CHANGE IN A LOW INTEREST RATE ENVIRONMENT
(Co-chaired with Jacek Osiński (ATC) and John Fell (FSC))

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Points for discussion

1. Why are rates so low?

2. What are the implications of low interest rate environment (LIRE) for financial stability?
    - In the different sectors (banks, non-banks, markets)
    - Across sectors

Some initial answers

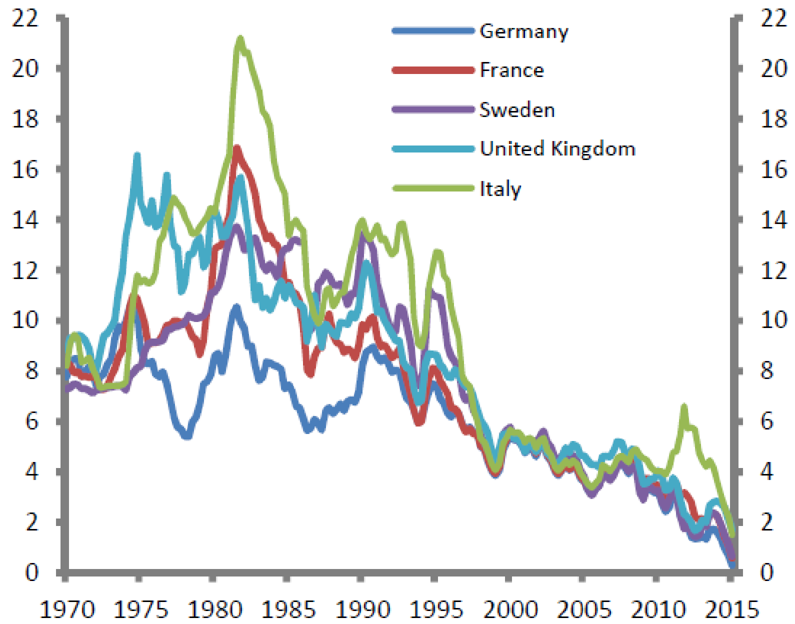
1. Why are rates so low?
   - **Structural factors** (low demographic & productivity growth) contribute substantially to the current low interest rate environment

2. What are the implications of LIRE for financial stability?
   - Three main groups of risks related to:
     - **Sustainability of business models**
     - **Increased (broad-based) risk taking**
     - **Changes in financial system structure**
   - Heterogeneity of risks across sectors/countries
   - Interrelations between risks
   - Systemic-wide analysis is necessary

1. Why are rates so low?

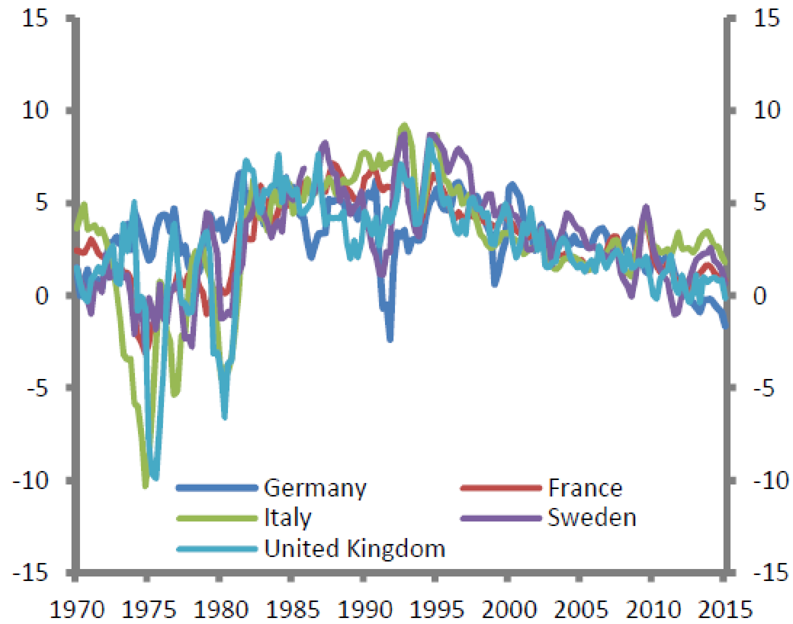
- Exceptionally low interest rates in the European Union
    - Decline started in the mid-80s, but accelerated in the aftermath of the global financial crisis and the European sovereign debt crisis

Chart 1.1: 10-year sovereign bond yields in selected EU-countries *(% p.a.)*



Source: International Monetary Fund (IMF).
Note: Last observation: 15Q1.

Chart 1.2: Real 10-year sovereign bond yields in selected EU-countries *(% p.a.)*



Source: IMF. *Note*: Real rates have been calculated by subtracting the four quarter growth rate of the GDP deflator (for Germany and the United Kingdom) or the consumer price index (for France, Italy and Sweden). Last observation; 2015-Q1.

1. Why are rates so low? (cont.)

Two main views on drivers of interest rates

- **Financial cycles** (Borio, 2012; Lo and Rogoff, 2015):
  - Economic agents accumulated **excessive debt** in the period before the crisis, based on optimistic expectations
  - *Consequence*: Extensive deleverage, dampening of investment and real interest rates, decline in nominal rates due to recession and accompanying monetary policy response
- **Secular stagnation** (Summers, 2014):
  - Interest rates have declined for **structural reasons**
    - demographic developments and lower TFP (supply side)
    - increased preference for scarce safe assets (demand side)
  - *Consequence*: Excess saving over investment and lower real interest rates, downward pressure on nominal rates

1. Why are rates so low? (cont.)

Different implications for the "duration" of low interest rates

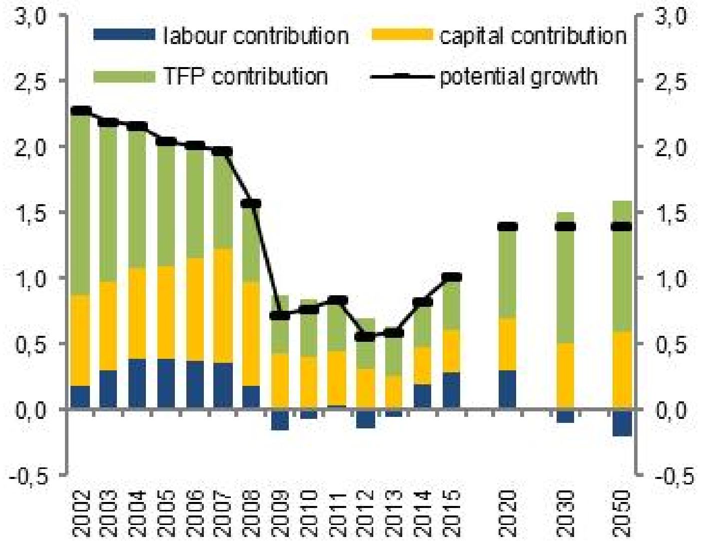
- **Financial cycles**
  - Interest rates may be affected for a long time but **not permanently**
  - When cyclical factors vanish, interest rates will increase again
- **Secular stagnation**
  - Interest rates have declined **permanently**
  - When cyclical factors vanish, rates will remain relatively low

These views suggest **two possible scenarios** for the development of interest rates going forward

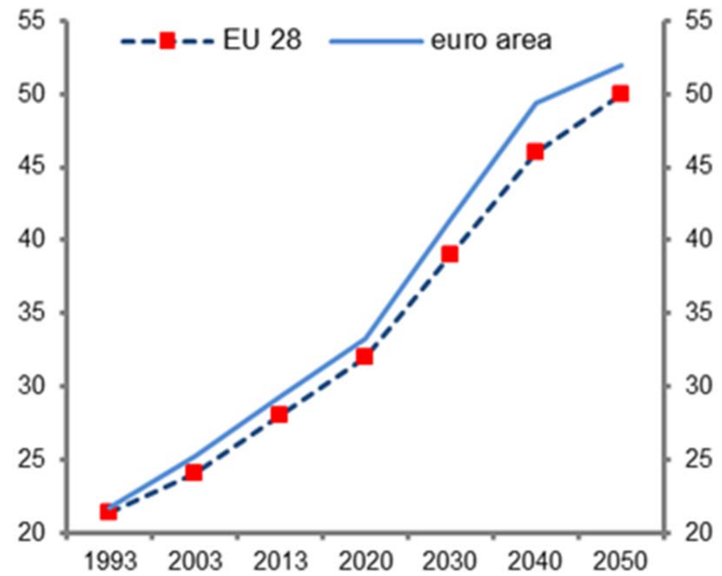
1. Why are rates so low (cont.)

- **"Low for long" scenario**: Low interest rates largely due to structural factors (low demographic & productivity growth)
- **"Back to normal" scenario**: Low interest rates largely due to cyclical factors (excessive debt & deleveraging needs)
- **Findings:** Structural factors contribute **substantially** to the current low interest rate environment. Model-based counterfactual analysis: significant TFP acceleration is needed for "back to normal" scenario to materialize

Contributions to EU potential growth *(%)*



Old-age dependency ratios *(%)*



Source: European Commission Ageing Report 2015.

1. Why are rates so low? (cont.)

Projections by international institutions (IMF and EC) show a series of downward real GDP growth revisions for Europe

- Median real growth forecasts have been revised in the last six years from 2,7% to 2.1% by IMF and from 2.4% to 1.8% by EC

Revisions in real GDP growth projections for the EU countries by the IMF and the European Commission *(%)*

	WEO – Oct. 2010	WEO – Oct. 2013	WEO – Apr. 2016	Aging report 2009		Aging report 2012		Aging report 2015	
	2015	2018	2021	2020	2025	2020	2025	2020	2025
minimum	1.2	1.2	0.9	1.5	0.9	1.0	0.7	0.1	0.6
first quartile	1.9	1.7	1.6	1.9	1.7	1.4	1.4	1.4	1.3
median	2.7	2.3	2.1	2.4	1.9	1.8	1.8	1.8	1.5
third quartile	3.5	3.1	2.9	2.7	2.3	1.9	2.0	2.1	1.9
maximum	5.0	4.0	4.0	3.9	3.2	3.3	3.4	3.0	3.0
std. dev.	1.0	0.8	0.8	0.6	0.5	0.5	0.6	0.6	0.6

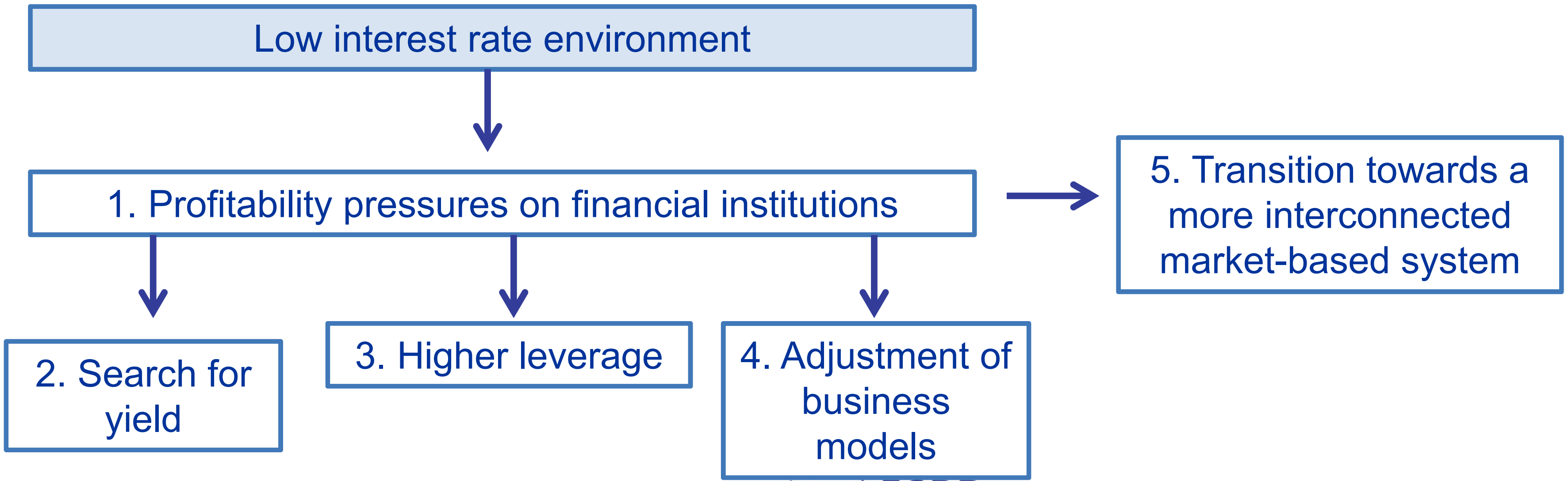
Source: International Monetary Fund and European Commission.
Note: The table reports the projections for EU28 by the IMF reported in the World Economic Outlook for the last year in the projection horizon: 2015 for the October 2010 WEO, 2018 for the October 2013 WEO and 2012 for the April 2016 WEO. As for the European Commission, the table shows the projections of potential output growth for the years 2020 and 2025 reported in the 2009, 2012 and 2015 Aging reports. Source: IMF World Economic Outlook and European Commission Aging Report.

2. What are the implications of LIRE for financial stability?

– Low interest rate environment puts **pressure on profitability** of financial institutions:
  – Particularly for institutions with longer-term return guarantees on liabilities
  – On banks due to suppressed net interest income

– Financial institutions withdraw from return guarantees towards intermediating unit-linked products, the result: **risks are transferred from financial sector to households**

– Low interest rate environment may be **speeding up transition of the financial system**
  – to more market-based intermediation (role of banks declines)
  – induces change in business models with implications for diversity among financial intermediaries



2. What are the implications for financial stability? (Cont.)

currently observed
conjectured future

Risks related to the sustainability of business models:

- Profitability and solvency pressures on return-guaranteed life insurers and defined-benefit pension funds
- Low profitability and weakness of banks' balance sheets

Broad-based risk taking:

- Potential for financial / real asset price misalignments and re-pricing
- Riskier balance sheets across financial system (lower-rated/less liquid investments, increasing leverage)

Risks related to changes in financial system structure:

- Risks related to shadow banking activities
- Interconnectedness and correlated liquidity risk

- *Heterogeneity of risks across countries / sectors*
- *Interrelations between risks*
- *Systemic-wide analysis* is necessary

Thank you for your attention!