Analysis

Low interest rates provide a stimulus but can also create risks

Financial stability, Interest rates | 09 June 2015 | Katja Taipalus, Kimmo Koskinen

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Accommodative monetary policy is necessary for price stability and economic recovery. However, abundant liquidity and the search for yield fuelled by low interest rates can also create risks for financial stability.



Accommodative monetary policy is necessary

Economic developments in the euro area have been subdued, albeit there are differences across countries. The European Central Bank (ECB) has pursued its inflation objective and supported economic recovery by holding interest rates at a low level and ensuring the availability of liquidity for banks. Despite these efforts, high levels of private and public sector debt are hampering economic recovery: borrowing is not attractive because debt burdens have remained high.

Banks central to monetary policy transmission

Low interest rates due to the relaxed monetary policy stance support the availability of market funding as an alternative to bank-based funding. At the same time, they also support acquisition of funding by banks themselves. However, even this better access to funding by banks has not increased bank lending as hoped.

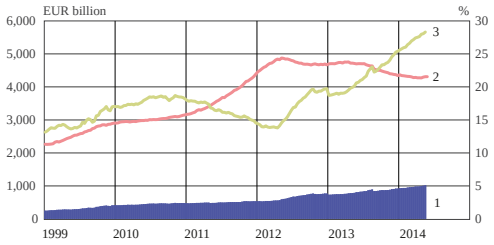
The latest statistical data[1] indicate that lending to the private sector by euro area banks has remained muted. The annual growth rate of lending to the private sector in the euro area was in fact 0.0% in April 2015. However, country-specific differences in lending are fairly substantial. The ECB's Bank Lending Survey (BLS) suggests that banks' expectations about credit developments are improving. Banks expect the ECB's expanded asset purchase programme (EAPP), in particular, to support lending growth in the future.

The BLS indicates that the EAPP has already improved banks' liquidity position and reduced their funding costs. At the same time, margins on loans to the private sector have narrowed, especially in southern Europe. The exceptionally low level of interest rates is, however, exerting further downward pressures on banks' net interest income. Banks that participated in the BLS expected their profitability to weaken on average over the next six months (Chart 1).

Chart 1.

Corporate loans granted by euro area banks, corporate bonds issued in euro area and relation of corporate bonds to bank loans

1. Corporate bond issuances (left-hand scale)
2. Corporate loans granted by banks (left-hand scale)
3. Stock of corporate bonds relative to bank loans (right-hand scale)



Source: European Central Bank.

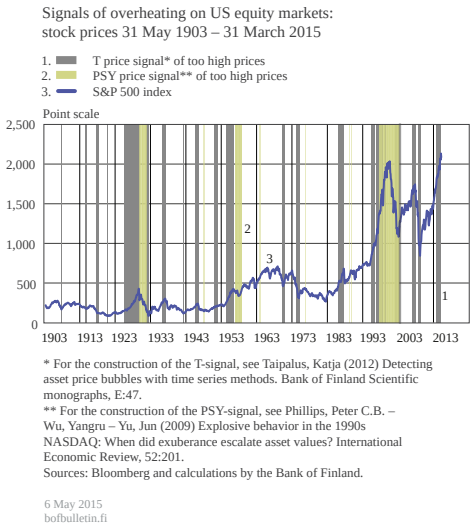
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Record reliance by corporations on market-based funding

The proportion of market-based funding in debt financing has grown recently, providing a necessary alternative to bank lending. Tighter bank regulation, digitalisation and persistently low interest rates are changing the competitive situation between banks and other actors in financial intermediation (see article 'Major changes underway in European banking sector').

Low interest rates have encouraged investors to search for yield through riskier products. The search for yield has actually helped to improve the functioning of the financial markets. Higher demand has raised stock prices – in some cases quite significantly – and reduced bond yields. Large corporations, in particular, have taken advantage of the low interest rates by issuing a record volume of bonds since the financial crisis. At the beginning of 2015, the stock of corporate bonds in the euro area exceeded EUR 1,000 billion (Chart 2). This represents growth of as much as 80% from the end of 2008. In particular, institutional investors such as investment funds, private and public pension funds and insurance companies have increased their investments in corporate bonds.

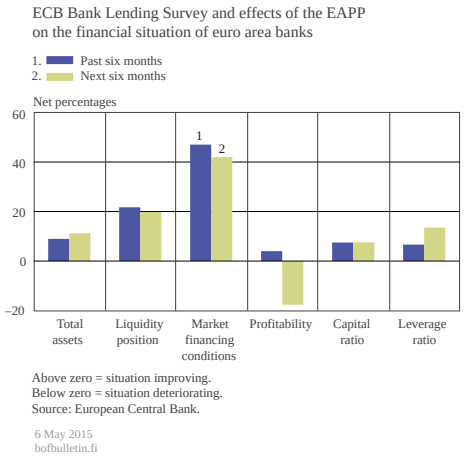
Chart 2.



Particular concern has been caused by the strong growth in issuance of high-yield corporate bonds and the historically low level of required returns and risk premia. The volume of euro-denominated bonds issued by high-risk corporations in Europe has already grown to around EUR 250 billion,[2] or about 25% of the corporate bond stock (Chart 3). Low interest rates and investor hunger for yield have maintained demand for these products, and risk premia have been declining in the early months of 2015.

A rise in interest rates could cause significant losses, especially to those who have invested in high-yield corporate bonds. Changes in investors' risk resilience could also endanger funding acquisition for many companies by increasing costs as interest rates rise and the provision of funding declines. The implications could be significant, particularly when considering that the banking sector has strongly reduced the amount of riskier corporate bonds on their balance sheets.

Chart 3.



From the perspective of financial stability, it is essential to monitor the growth and changes in corporate bond financing and other funding acquired outside of the banking sector (see article 'Major changes underway in European banking sector'). In assessing the success of policy action to stimulate the economy, it is important to examine where funding is channelled: in order to support economic growth, funding should be channelled primarily into productive investment, not just to financial instruments.

Search for yield can distort prices

There are fears that equity and bond prices, in particular, and partly also real estate prices on the international financial markets have already exceeded the level supported by economic fundamentals. Investor search for yield has increased demand for high-risk instruments. This has created fertile ground for the development of various financial innovations. Innovations reallocate risks and create new linkages between the various actors in the financial system. In order to mitigate uncertainties about the reallocation of risks in times of disruption, new innovations must also be sufficiently transparent.

Even though there are fears of overheating on the markets, it is hard to detect unambiguous signs of an overvaluation of asset prices. However, in the United States, for example, there is a general fear that equity market valuations are already too high relative to the economic fundamentals.

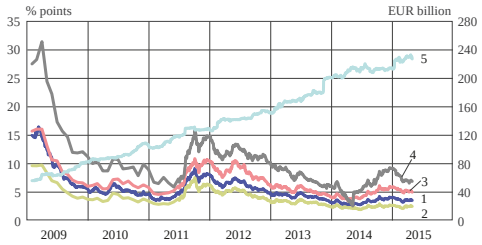
Equity valuations can be analysed through various early warning indicators. However, the signals given by such indicators should be interpreted with caution. Several different tools need to be analysed before drawing conclusions about overvaluation on the equity markets. At present, many of the early warning indicators are already providing signals of elevated stock prices, including in relation to dividends on stocks (Charts 4 and 5). From the perspective of financial stability,

therefore, it is necessary to monitor whether the indicators continue to give signals of price overheating going forward.

Chart 4.

Euro denominated high-yield corporate bonds issued in Europe and their option adjusted risk premia according to credit rating

1. Total Europe (left-hand scale)
2. BB (left-hand scale)
3. B (left-hand scale)
4. CCC (left-hand scale)
5. High-yield bonds, stock (right-hand scale)



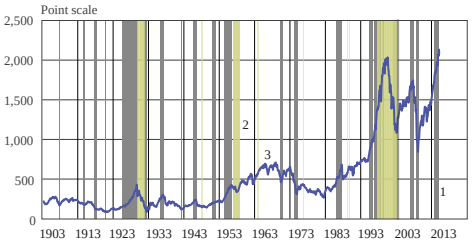
Bonds of high-risk corporations (excl. financial corporations).
Source: Barclays.

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Chart 5.

Signals of overheating on US equity markets: stock prices 31 May 1903 – 31 March 2015

1. T price signal* of too high prices
2. PSY price signal** of too high prices
3. S&P 500 index



* For the construction of the T-signal, see Taipalus, Katja (2012) Detecting asset price bubbles with time series methods. Bank of Finland Scientific monographs, E:47.
** For the construction of the PSY-signal, see Phillips, Peter C.B. – Wu, Yangru – Yu, Jun (2009) Explosive behavior in the 1990s NASDAQ: When did exuberance escalate asset values? International Economic Review, 52:201.
Sources: Bloomberg and calculations by the Bank of Finland.

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Notes

1. European Central Bank, Balance Sheet Items statistics (BSI), 29 May 2015. ↑
2. Barclays. ↑

Keywords

financial intermediation, interest rates, overheating