Box 3

Longer-term developments in nominal and real interest rates in the euro area

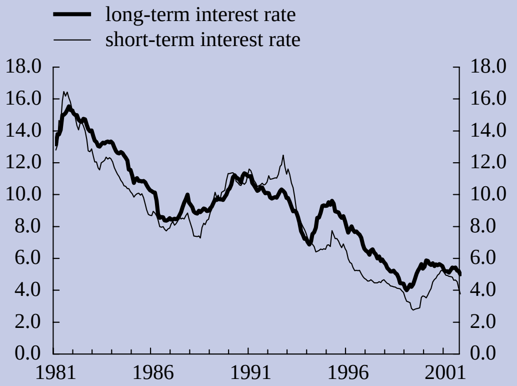
Nominal and real interest rates in the euro area have remained, since the start of Stage Three of EMU, at very low levels when compared to their averages over the two previous decades. Such structurally low levels of nominal and real interest rates reflect the respective effects of monetary and fiscal policies geared towards a stable macroeconomic environment. The low level of current interest rates indicates that financing conditions in the euro area are among the most favorable in decades.

Measures of short and long-term nominal interest rates are presented below. Short-term rates are based on a measure of the average three-month interbank rates in the euro area. The measure of long-term nominal rates relies on the average nominal ten-year government bond yield.

The level of nominal interest rates for the euro area that has prevailed since the start of Stage Three of EMU is significantly lower than in the 1980s and the 1990s (see the chart below). From 1981 to 1998, the euro area average for short-term nominal rates stood at 9%, compared to 3.9% on average since the start of Stage Three. The pattern for long-term nominal interest rates has been similar. Their average between 1991 and 1998 stood at 7.9%, compared to 5.1% on average since the start of Stage Three of EMU.

Nominal interest rates

(percentages per annum; monthly data)



Source: ECB.
Note: Before January 1999, short-term rates are computed as a weighted average of nominal three-month interbank rates from countries that now form the euro area and on the three-month EURIBOR rate thereafter. The long-term rate is a weighted average of ten-year nominal bond yields for countries that now form the euro area.

The computation of real interest rates should in principle involve adjusting the nominal rates by measures that reflect inflation expectations. In this respect, when looking at long-runs of back series of data, realized HICP inflation is likely to be a good proxy of past inflation expectations, as shocks to inflation typically tend to cancel each other out over longer periods of time. By contrast, for the purpose of assessing current levels of real interest rates, taking the current inflation rate may not be reflecting current inflation expectations. For this reason, in order to assess the current situation, a direct measure of inflation expectations is also provided in the table below.[1]

In addition to levels of real interest rates for the euro area, averages are reported in the table for Germany as well. Average interest rates for the euro area prior to Stage Three were biased by exchange rate risk premia that disappeared thereafter. Since for Germany these premia were small during this period, historical German averages should be more comparable with euro area levels after the start of Stage Three.

Over the entire period from 1981 to 1998, the euro area average for short-term real interest rates was 4.6%, while it was 3.9% for Germany. Since the start of Stage Three of EMU, the average for the euro area has been much lower, at 1.9%. The evolution of long-term real interest rates has been similar. In Germany, the average rate stood at 5.2% between 1981 and 1990, and at 4.5% between 1991 and 1998. In the euro area, it was 5.2% in the latter period. This compares with an average of 3% for the euro area since the start of Stage Three.

Measures of real interest rates

(percentages per annum; monthly data)

	Short-term real interest rate		Long-term real interest rate	
Period	**euro area**	**Germany**	**euro area**	**Germany**
1981-1998 1)	4.6	3.9	-	4.9
1981-1990 1)	4.7	4.2	-	5.2
1991-1998 1)	4.6	3.5	5.2	4.5
1999-October 2001 1)	1.9	-	3.0	-
Current value (range) 2)	1.1-1.8	-	2.3-3.0	-

Source: ECB.
1) Deflated by average annual consumer price inflation over the period.
2) The range takes into account two deflators (September 2001 annual HICP inflation rate and expected annual HICP inflation in 2002 according to September Consensus Forecasts); see the box on "Recent developments in real interest rates in the euro area" in the April 2001 issue of the Monthly Bulletin for a more detailed discussion.

1 See the box on "Recent developments in real interest rates in the euro area" in the April 2001 issue of the Monthly Bulletin for a more detailed discussion.

Current levels of short and long-term real interest rates in the euro area range from 1.1% to 1.8% and from 2.3% to 3% respectively.

The low levels of long-term nominal interest rates prevailing in Stage Three of EMU primarily reflect the progress made in reducing inflation in the euro area. They indicate that a monetary policy focused on maintaining price stability has resulted in low inflation expectations and reduced inflation uncertainty. Furthermore, the currently low levels of long-term interest rates reflect the progress made in fiscal consolidation since the early 1990s. Such low levels of long-term interest rates should be an important factor supporting economic growth in the euro area. In fact, investment decisions of the private sector in the euro area are, in large part, linked to long-term interest rates.

For the maintenance of favourable longer-term financing conditions in the euro area, it is thus important to preserve the credibility of the current policy framework. In this respect, fiscal policy has to play its role by adhering to its medium-term objectives as laid down in the Stability and Growth Pact. Any deviation from this medium-term orientation could be detrimental to maintaining the current favourable financing conditions.

At the same time, the best contribution which monetary policy can make to preserving favourable financing conditions is to safeguard its credibility in maintaining price stability. Monetary policy not only has an effect on inflation expectations (and thereby on nominal interest rates) but also on risk premia, and thus also on real interest rates. From the point of view of the functioning of the economy, high risk premia impose additional costs on the private sector in raising finance, thus hampering economic growth. In order to contribute efficiently to the long-term growth prospects of the euro area, the best monetary policy can do is to preserve a stance clearly focusing on the maintainance of price stability, thereby also ensuring the low degree of policy-induced uncertainty that has been achieved so far.