Research Working Papers

Does Risk-Taking Increase or Decrease with Higher Interest Rates?

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Interest rates can affect borrowers' risk-taking indirectly by changing their demand for credit and volume of investment.

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We present a framework that accounts for how interest rates affect risk-taking by borrowers indirectly, by changing the borrower's demand for credit (investment size). We find that this borrowing demand effect runs counter to the direct borrowing rate effect, and risk-taking can increase or decrease with higher rates depending on the relative strength of these effects. We show that the borrowing rate effect dominates when the borrower's share of project returns is increasing in investment, so risk-taking increases with interest rates. However, the borrowing demand effect dominates when the borrower's share of project returns is declining with investment demand, so that risk-taking decreases with higher interest rates. These results contribute to the understanding of linkages between monetary policy and financial stability. We apply our findings to study how lender competition affects risk-taking.

JEL Classificiations: D82, E52, G21, L13

Article Citations

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Related Research

- Martinez-Miera, David, and Rafael Repullo. 2017. "Search for Yield." *Econometrica*, vol. 85, no. 2, pp. 351-378. Available at https://doi.org/10.3982/ECTA14057

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