BanRep Blog: Why has the Performance of Interest Rates on Government Bonds been so Different from the Policy Interest Rate since 2024?

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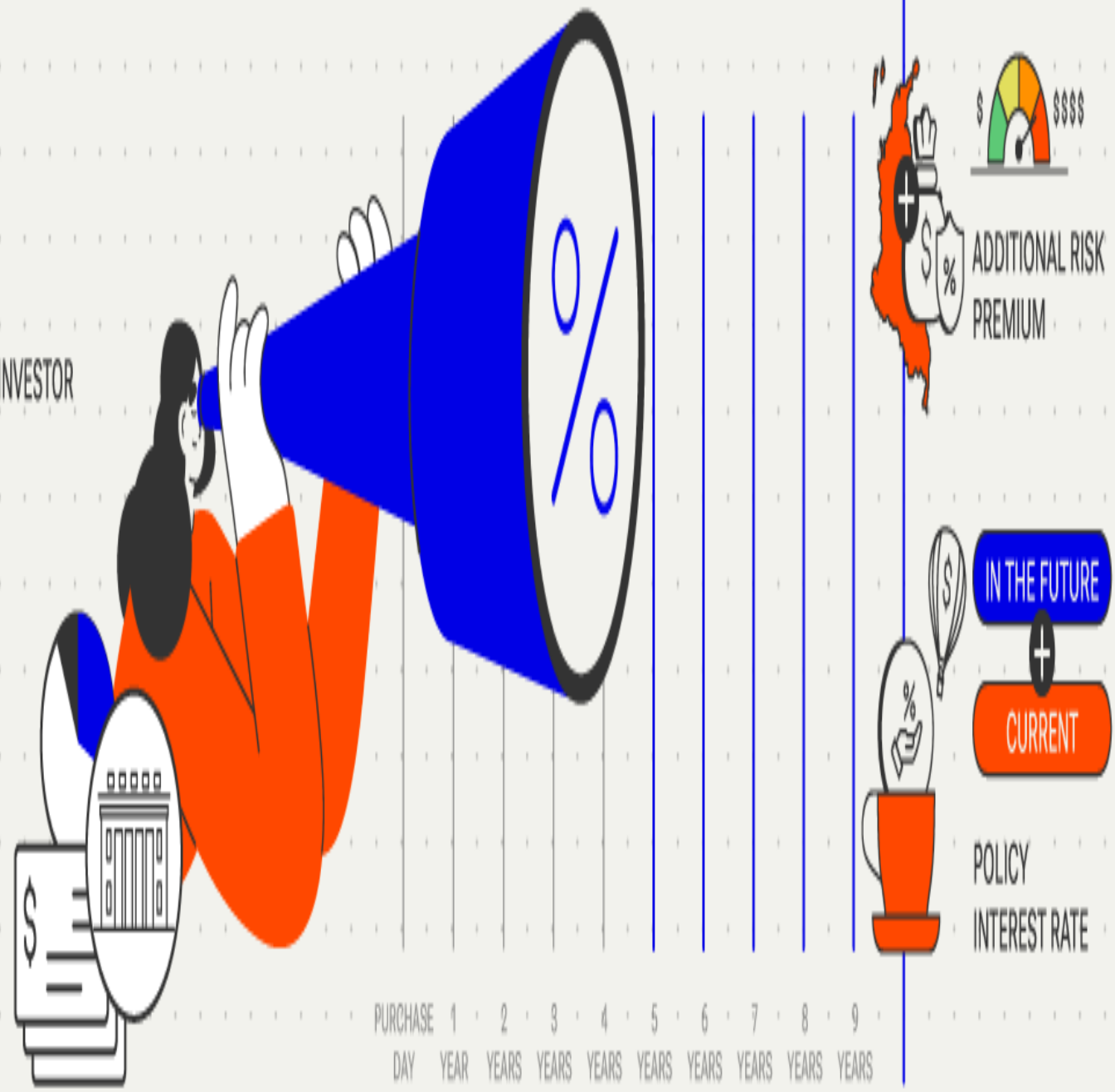
Since early 2024, interest rates on long-term Colombian government debt bonds, hereafter referred to as government bonds, have been increasing. This means that the government must pay more interest on its debt, so a larger share of its revenues must be allocated to cover such interest payments instead of other expenditures such as healthcare, education, security, or infrastructure. Another way of looking at this is that if these other expenditures are not reduced, the government will have to take on more debt, which, in turn, will lead to higher interest payments. Therefore, it is essential to understand which factors explain the performance of interest rates on government bonds.

The interest rate on government bonds has two main components:

The first component corresponds to the interest rate at which investors would be willing to purchase government bonds if there were no repayment risks or unexpected changes in their prices. This rate is typically associated with *Banco de la República*'s (the Central Bank of Colombia, *BanRep*) policy interest rate, which applies to very short-term loans, generally overnight. However, since government bonds have longer maturities (e.g., 2, 5, 10, or even 30 years), it is necessary to consider not only BanRep's current policy interest rate, but also the rate at which investors expect it to be in the future. These expectations about the policy interest rate are usually closely related to expectations about inflation dynamics, since *Banco de la República* must respond with higher interest rates when expected inflation is higher.

The second component is the additional risk premium required by buyers of government bonds for taking risks related to public debt. This risk premium depends on several factors, one of which is the strength of the government's finances. In general, investors consider that when public debt and the gap between government expenditures and revenues (known as the fiscal deficit) are low, the government has a strong financial position. Conversely, if government debt and the fiscal deficit rise rapidly and reach high levels, investors will perceive a deterioration in the government's finances and will demand a risk premium for purchasing riskier bonds.

Interest Rate Components of Long-Term Government Bonds



In summary, the interest rate on government bonds depends on the policy interest rate set by *Banco de la República* for short-term, risk-free operations, on the policy rate that investors expect in the future, and on the risk premium they require to cover long-term risks inherent in public debt.

Graph 1 exhibits the performance of interest rates on 10-year government bonds, as well as BanRep's observed and expected interest rates. As can be seen, the policy interest rate (blue line) has decreased by four percentage points, from 13.25% to 9.25%, since early 2024, which contrasts with the two-percentage-point increase in the interest rate on government bonds (orange line).

Graph 1: Ten-Year Government Bond Interest Rate and *Banco de la República*'s observed and expected Policy Interest Rates



BanRep's interest rate (blue line) has decreased since early 2024, while expectations regarding the policy interest rate in the future have remained relatively stable (green line). This contrasts with the interest rate increase on government bonds (orange line) over the period considered.

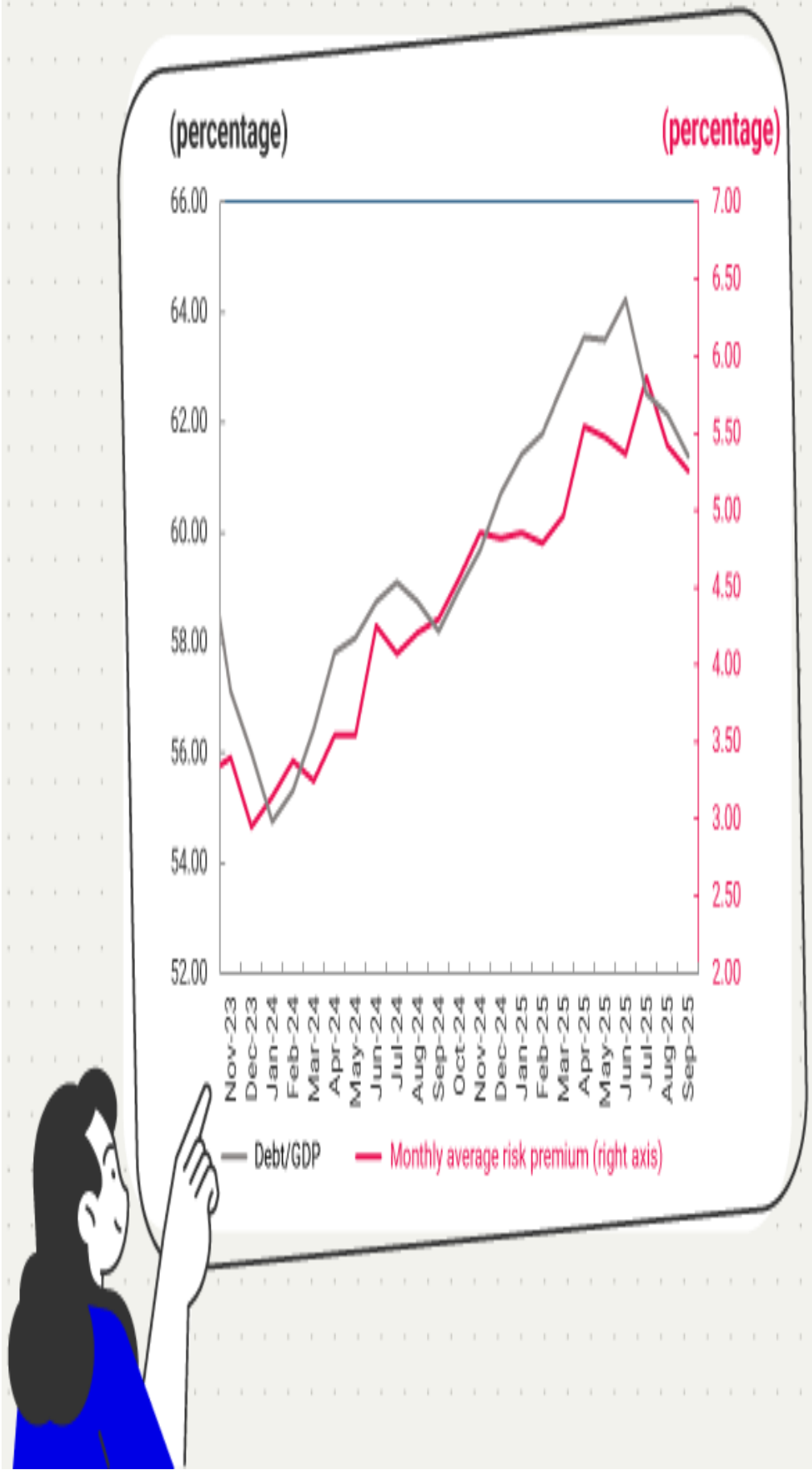
Source: *Banco de la República*.

Therefore, the increase in government bond interest rates since early 2024 cannot be explained by the performance of *Banco de la República*'s policy interest rate, which, as noted, decreased during that period. Neither can it be explained by changes in expectations regarding the policy interest rate in the future, which remained relatively stable over the period considered, probably because medium- and long-term expected inflation also remained stable or trended downward. This is reflected in the green line in **Graph 1**, which measures the expected value of BanRep's policy interest rate at each point in time.

The increase in government bond interest rates shown in **Graph 1** therefore reflects the risk premium component associated with public debt. This component is measured precisely by the difference between the interest rate on government bonds and policy interest rate expectations, that is, by the difference between the orange and green. This risk premium is shown by the red line in **Graph 2**, which, as shown, has risen considerably since early 2024, even when considering a partial reversal of that increase between July and October 2025.

As shown in **Graph 2**, the risk premium component for public debt (red line) performs similarly to the government's level of debt as a share of the economy's output (grey line). In other words, the risk premium required by investors to cover debt risk has increased in line with the deterioration of public finances, as indicated here through the government debt-to-GDP ratio.

Graph 2: Public Debt as a Share of GDP and Risk Premium



The risk premium component for public debt (**red line**) performs similarly to the government's level of debt as a share of the economy's output (grey line).

Source: Ministry of Finance and Public Credit and *Banco de la República*.

In conclusion, the increase in government bond interest rates since early 2024 is mainly explained by the additional risk premium demanded by investors who purchase these securities to cover the risks associated with the public finances situation, and not by *Banco de la República*'s policy interest rate.

Related Economic Concepts

- Government Bonds
  - These are debt instruments issued by the government. In Colombia, the most widely known are TES (Treasury Bonds). They are traded on the financial market and have different maturities and interest rates (fixed or variable).
- Additional Risk Premium
  - It is the additional amount above the risk-free rate that investors require to cover the long-term risks inherent to public debt operations. It is measured as the difference between the interest rate on government bonds and expectations of *Banco de la República*'s policy interest rate.
- Fiscal Deficit
  - This is the shortfall between fiscal revenues (such as taxes) and public expenditures over a given period. It is generally financed with public debt, that is, by issuing bonds such as TES.
- Public Debt
  - It is the money a government borrows to finance its expenditure when its revenue (for example, taxes) is not sufficient.
- Policy Interest Rate
  - It is the interest rate at which *Banco de la República* lends or receives money to/from financial institutions, generally for a one-day term. This rate is the main policy tool of *Banco de la República*.
- Risk-Free Rate
  - It is the rate at which investors would be willing to purchase government bonds if there were no repayment risks or changes in their prices. This rate is usually associated with *Banco de la República*'s policy interest rate, which is applied to very short-term loans, generally overnight.

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Related Questions and Answers

What determines the interest rate on government bonds?

The interest rate on government bonds depends on the policy interest rate set by *Banco de la República* for short-term, risk-free operations, on the policy rate that bond investors expect in the future, and on the risk premium they require to cover the risks of long-term operations inherent to public debt.

What does the additional risk premium depend on?

This risk premium depends on several factors, one of which is the strength of the government's finances. If investors perceive the government's financial situation as solid, the risk premium will be lower; if, on the contrary, they perceive that the government's debt and fiscal deficit are rising rapidly and reaching high levels,

investors will perceive this as a deterioration of the government's finances and will demand an additional risk premium.

How have government bond interest rates, *BanRep*'s policy interest rate, and the additional risk premium required by government bond buyers behaved since early 2024?

Banco de la República's policy interest rate, both observed and expected, has declined or remained stable since the beginning of 2024. In contrast, the interest rate on government bonds and the additional risk premium have increased during the same period.

What has explained the recent increase in government bond interest rates?

The interest rate on government bonds and their risk premium component have risen, while the policy interest rate has decreased or remained unchanged. Given this, the recent increase in the 10-year government bond interest rate is related to the risk premium for the risk of these bonds, due to the increase in public debt, and not to the performance of *Banco de la República*'s policy interest rate.

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Fuente: https://d1b4gd4m8561gs.cloudfront.net/en/blog/performance-interest-rates-government-bonds