Why are short-term interest rates negative in Germany and France?

Article for the FT Deutschland - August 2012 - Denis Kessler

This is the first time that we have seen negative nominal interest rates in both Germany and France, alongside very high government bond rates within the Eurozone in Spain and Italy.

The first (obvious) explanation for this lies in the risk premiums demanded by investors. Investors take account of the respective ratings for the four countries and note – as per S&P – that Germany is rated AAA and France AA+, while Italy and Spain are rated BBB+. These rating differences help to explain the differences between the borrowing rates for the Treasuries of these countries, but they do not justify the negative nominal interest rates in Germany and France. And if we take inflation into account, the real interest rates are even more negative.

The second explanation is linked to the monetary policy followed by the ECB. This highly accommodating monetary policy, particularly since the arrival of Mario Draghi last November, has led to historically low monetary rates, with few quantitative limits on banks’ debts with the issuing institution. Nevertheless, the ECB intervention rates remain positive, even though their low levels have weighed on the rate curve, particularly in the short term.

The third reason people point to is an unbalanced situation on the short-term loanable funds market. Demand is much higher than supply. This imbalance is advantageous to well-rated borrowers – i.e. the Treasuries on either side of the Rhine, which are taking advantage of it by offering negative interest rates. It’s easy to pinpoint the source of this imbalance. As the Euro crisis has developed, fund managers have, for certain countries, implemented asset allocation policies that are increasingly restrictive in quantitative terms. For example: regardless of the Italian rate offered, a fund will limit investments in the country to 3% of the Euro assets managed. As these restrictions by country are preceded by currency constraints – the fund will limit its investments in the Eurozone to such and such a percentage, which is constantly being lowered -, short-term Euro investments are constantly becoming more and more concentrated on the purchase of Bunds, through a kind of funnel effect. This trend gains momentum over time, because the allocations to at-risk countries are constantly decreasing – when they are not simply eliminated, whether temporarily or definitively. Thus people are driven to those rare investments that permit a reinforced risk management policy – these investments are authorised regardless of their yields, even if these are negative. People have to put their cash somewhere, and the recurring doubts over the solvency of the banking system do not
encourage large deposits with the banks. All the more so given that many banks, although they are domiciled outside the peripheral countries, have significant exposures to them. It is a well-known fact that it costs a lot to rent a safe, and that people are willing to pay simply to regain what they have deposited there at a later date.

The fourth reason, and no doubt the most pertinent one, concerns the possible break up of the Eurozone. Take the example of a Spanish investor. He has some Euros that he wants to invest for a three-month period. If he thinks there is a 5% chance of Spain leaving the Eurozone, and consequently that the peseta would be devalued by 30%, he will be ready to accept a negative interest rate from a foreign issuer in order to regain some Euros at the end of his investment. Then the decision to accept a negative interest rate seems perfectly rational.

All of these reasons are easy to apply to Germany, a safe and respected investment. But how has it come about that France, with its less favourable economic and financial situation, can also issue Treasury bonds with negative interest rates? The answer is simple: investors believe, no doubt correctly, that the break up of the Eurozone – if it had to take place – would only be partial and would strengthen the hard core of the monetary zone outside of the peripheral countries. There would still be a Eurozone - it would certainly have fewer countries in it, but it would be less disparate than the zone currently in force. And for historical and political reasons, Germany and France would obviously be part of it. Investing in French government securities – or in German government securities – therefore provides insurance against the risk of a partial break up of the Eurozone. And, as with all insurance, there is a premium to pay. This premium actually seems fairly modest, if you consider the scale of devaluation of the currencies of those countries that would be forced, under duress, to leave the Eurozone. In the end, risk premiums on sovereign Eurozone securities, whether positive or negative, would just be exchange rate premiums on currencies that are virtual today but could reappear tomorrow if the Eurozone breaks up.