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Negative rates: how did we get here?

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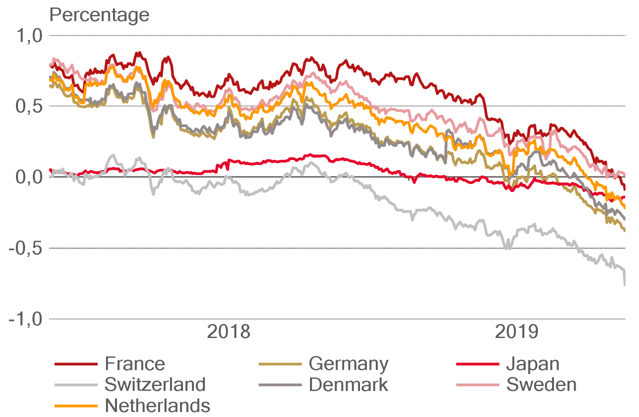
Today, several governments can take out loans on financial markets at negative interest rates – which means that investors are paying to lend them money. If this situation, unprecedented in history, may at first seem absurd, it is in fact absolutely rational at a time when investors are becoming increasingly pessimistic about the economy in a world where underlying economic fundamentals remain essentially weak.

In the wake of Mario Draghi's speech on 18 June, in which the President of the European Central Bank said he was ready to do more to support the economy, **the French ten-year government bond rate dipped, for the first time in its history, into negative territory**. Yields have continued to sink after the nomination of Christine Lagarde as European Central Bank president. Although this is not the first time the French government has borrowed at negative interest rates (the phenomenon began in 2014), thus far, this concerned borrowings over shorter periods of time.

10-year government yields



Source: Thomson Reuters Datastream

France is not alone in this situation; several governments (Germany, Switzerland, Japan, etc.) also benefit from negative-rate loans. **Today, the global stock of negative-rate bonds (all durations and issuers combined) is close to its all-time high at nearly $12,000 billion**, according to Barclays' data.

At first glance, this situation seems absurd: **why would investors agree to pay to lend their money?** To answer this question, we must first take a look back at the monetary policies implemented by the main central banks in the aftermath of the 2008 financial crisis.

To restart their economies and fight deflationary pressure, **the central banks** of the major developed countries **cut their interest rates to zero and even**, for some of them (such as the ECB), **slightly below zero**. Once their interest rates had reached zero (or a bit lower), these banks turned towards **unconventional monetary policies** by launching vast long-term asset purchase programmes (Quantitative Easing or QE) **in order to exercise downward pressure on long-term interest rates**.

The long-term nominal interest rate level, which is determined by the forces of supply and demand for securities on the bond market, **reflects**

- **Anticipation of average short-term interest rates** until bond maturity
- Plus, **a term premium** (i.e., the additional yield received by investors for purchasing long-term bonds rather than a series of short-term bonds over the same period).

Since the 2008 financial crisis, long-term interest rates have shown an impressive decline, as a result of three main phenomena:

- The reduction of central banks' **key rates**, sometimes to below zero
- **Investors' anticipations** that short-term rates will remain low over a prolonged period
- The sharp rise in net demand for long-term securities, which has led to a major decline in **term premiums**

The surge in net demand for long-term securities (i.e., the decline in the term premium) is linked to a whole series of specific factors:

- **Central banks** have become **purchasers of large amounts of long-term debt** as part of their unconventional policies
- The **tightening of solvency regulations** has forced long-term investors (banks, pension funds, insurance companies) to accumulate sovereign bonds, regardless of their yield
- The purchase of bonds at negative rates can be underpinned by a **speculative reason.** This is the case, for example, of investors who anticipate an appreciation of the currency of issue of assets, betting on a foreign exchange gain that will largely compensate for the negative yield, or of investors anticipating a prolonged period of deflation, resulting in *negative* nominal yields turning into *real* positive yields
- **Fear of the future** can lead investors to purchase government bonds, even at negative yields, seen as safe-haven investments

It is the **low or even negative interest rate policy of central banks**, combined with **the sharp increase in the demand for bonds perceived as risk-free**, which has, in addition, coincided with a **decline in the global supply of "safe" assets** (downgrading of several sovereign debts, particularly in the periphery of the Euro zone), which **explains** the surge in bond prices, and therefore **the descent of long-term rates into negative territory**.

For some, negative rates reflect an imbalance imposed by central banks. However, central banks only accommodate underlying economic trends. **In many regions, the level of interest rate needed to balance savings and investment is probably now around zero.**

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