12th IMF Forum on Managing Sovereign Risk and Public Debt

"MANAGING SOVEREIGN DEBT: A SEISMIC SHIFT IN DEMAND AND SUPPLY DYNAMICS"

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Session 3:

"Does the Role of Central Banks in Debt Markets Need a Re-examination?"

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I appreciate the opportunity to participate in a conference with debt managers and central bank representatives to discuss the role central banks can play with respect to the current crisis in debt markets.

1. Current market conditions: perverse incentives and perverse effects

In Europe sovereign risk and its interaction with bank risk, together with flight to quality have resulted in a polarization of conditions in financial markets. The cost of funding has reached record highs in some countries and record lows in others. Of course the most immediate risks are felt in the countries where rates are peaking. However, looking ahead, the countries which are now enjoying sharp reductions in their costs of borrowing will also be affected and not just because of possible contagion effects. The result could be a period of prolonged malfunctioning of financial markets.

Today, investors' main concern seems to be their ability to recover the principal, rather than paying exceptionally high prices to buy Bunds or Treasuries. However, banks and institutional investors badly need risk-free assets as a benchmark for portfolio investments, as an instrument for treasury operations, and as collateral for inter-bank transactions. The stock of risk-free asset available in the market is decreasing because higher credit risk, purchases by central banks (mainly in the US and Japan) and smaller budget deficits (in Germany) are reducing their supply at a time when the flight to quality, the increase in collateralized instruments for inter-bank transactions and regulatory changes are increasing the demand for these assets. Furthermore, even if we don't know when it will

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happen, it is inevitable that prices will adjust and mean revert to more normal values, causing investors to incur large losses, with negative consequences for the liquidity of financial markets.

The search for protection by individual investors is therefore amplifying both credit risks and market risks. The problems arising from such a situation are evident, but the incentives for individual countries to correct them are not operating properly. For the countries hit by the crisis, fiscal imbalances are being adjusted to cope with the sharp increases in borrowing costs: however, the self- fulfilling dynamics of higher interest rates and lower growth are not rewarding their efforts, making it extremely difficult to move further along the path of budget restrictions and structural reforms. By contrast, for the countries which are enjoying the flight to quality, the improvement in credit and funding conditions reduces the pressure to make the efforts needed to deal with imbalances. Ending the crisis is in everyone's interest, but this is more difficult to see for creditor countries and those benefiting from large flights to quality, because the problems they face are perceived as not immediate.

2. Central bank actions: Impact of SMP and LTRO on market and funding liquidity

In Italy the Securities Markets Programme (SMP) had a significant, although possibly short-lived, impact on prices in the secondary market for government securities (Figure 1). We also observed some positive impact on the main indicators of market liquidity, like turnover, bid-ask spreads and market depth (Fig. 2). Investors felt, however, that the programme was not sufficient to narrow sovereign spreads.

Much more important was the impact of the massive injection of liquidity through the two 3-year Longer Term Refinancing Operations (LTROs), the easing of eligibility requirements for collateral and a reduction of reserve requirements. The two LTROs had a positive effect on market confidence. Euro-area banks' medium-term financing risks declined sharply, especially for credit institutions in the countries under greatest pressure. The risk premiums on bank funding immediately declined (Fig. 3). In the first few months of 2012 the banks of vulnerable countries (such as Italy and Spain) resumed issues of unsecured medium-term bonds on international markets. Various indicators of the fear of catastrophic events also subsided.[1] The impact on the credit channel is difficult to measure but some indicators show that the restriction on supply that occurred in the last weeks of 2011 eased in the following weeks, although demand for loans remained very low because of the deteriorating market conditions. Prospects are still uncertain, however, due to the renewed tensions on the financial markets since April. Spreads are increasing again, rising to levels very close to those prevailing before the exceptional measures decided by the ECB last fall (Fig. 1).

On the issue of the possible adverse impact on markets of the unconventional measures I will mention two aspects. First there was an obvious negative impact on the turnover of the inter-bank market, especially the unsecured component. We believe this effect will be long lasting but will stimulate the development of market infrastructures which will rely more on collateralized lending. Second, as far as the SMP was concerned, some negative impact on the market derived from the concentration of the purchases on a limited number of securities, coupled with some lack of transparency as to the size of the program, the target interest rate, the securities included in the program, and the maturity buckets. The result of these ambiguities was occasional tensions in repo markets, where market makers typically fund their trading books and cover their short positions. In some cases market makers experienced difficulty in delivering the targeted securities.

The lesson learnt is that with programs of this type, full transparency in the disclosure of the objectives and features of the program is essential. Another important aspect is a clear-cut separation between the roles of central banks and debt managers, because when these programs are in place the debt manager could be tempted to tailor its funding program to the possible demands of the central bank or conversely the actions of central banks could be thwarted by changes in the issuance policy of debt managers[2]

3. A stabilization program for debt markets?

To understand why central bank actions have not so far been able to restore market confidence, it is important to spell out the dynamics of this crisis more clearly. The run on debt we are experiencing in Europe is in many respects similar to a run on deposits. Like many deposit runs this debt crisis is triggered by the perception of increased risk of default

[1] Banca d'Italia, Financial Stability Report, April 2012, p. 7.

[2] For instance a policy to lower long term rates through bond purchases could be jeopardized by a large increase of long term bonds' issues

by the counterparty but amplified by information asymmetries, contagion effects and endogenous market dynamics.

Of course markets' concerns about the creditworthiness of the countries most affected by the crisis are to some extent legitimate and in fact one wonders why for many years markets did not sufficiently differentiate sovereign issuers. However it is extremely difficult for the market to properly assess the default probability of a sovereign issuer, which is ultimately an idiosyncratic political act. Empirical studies based on the experience of emerging markets confirm that markets have a poor track record in assessing sovereign risk.[3] On their part European authorities contributed to the confusion with their ambiguous positions on Private Sector Involvement, seniority of debt to official institutions and even the possibility of a Euro exit.

Once an expansion of risk spreads is set in motion, it tends to be amplified under the impact of various factors that act as automatic "destabilizers": pro-cyclical application of haircuts in repo contracts and derivative transactions; pro-cyclical adjustment of margins by central counterparties and other market infrastructures; lagged response of Credit Rating Agencies to deteriorating conditions. Finally, particularly in the case of the euro area, the illiquidity of markets leads to bank illiquidity and to a bank-crisis/debt-crisis vicious circle, further amplifying the impact of the initial shock on debt and growth in the countries in crisis.

An important difference between bank deposits and bonds is that sight deposits can be redeemed at par at any time, while for bonds the loss in their market value during a "run" may progressively reduce the incentive for investors to convert them into other assets. However, the recent experience has shown that because of the mechanisms I have just described and the link between market illiquidity and funding illiquidity, market operators may be forced to sell their assets in adverse circumstances, at fire-sale prices, to acquire the liquidity needed to meet the various market requirements.[4] Hence a liquidity crisis triggered

[3] "bond markets have a rather mixed-if not poor-track record in pricing default probabilities correctly and according to an IMF staff note the bond market tends to sound false alarms (see "Defaults in Today's advanced Economies: Unnecessary, Undesirable, Unlikely", IMF SPN 10/12) " (Morgan Stanley, Feb 7,2011, p.10).

[4] U. Bindseil and A. Winkler, 2012 "Dual liquidity crises under alternative monetary frameworks – a financial accounts perspective" mimeo ECB.

by some initial legitimate concerns about the creditworthiness of the counterparty can spiral out of control and evolve into a solvency crisis for both banks and sovereigns.

A panel model recently developed within the Bank of Italy, which uses data for 10 euro area countries from 2000 to 2011, provides estimate of the “fair” value of the risk spreads in debt markets as a function of various “fundamental variables”, namely the budget deficit, the debt to GDP ratio, the expected growth in real GDP, as well as measures of possible contagion effects. The results, reported in fig. 4 clearly show that the market underestimated sovereign risks in the period between 2002 and 2007 and has been overestimating it since 2008. According to this model, the fair value of the Bund to BTP spread on 1st October 2011 would have been 190 basis points lower than the actual value of 365 [5].

Only a program of bank recapitalization and the creation of a credible and effective safety net can prevent a liquidity crisis from snowballing into major market disruptions and misallocation of resources. In the euro area this would imply moving decisively in the direction of a banking union with some shift of sovereignty to the supranational level. It will be necessary to have a European fund to recapitalize banks, a deposit guarantee scheme, centralize banking supervision, all issues that are being discussed in these days by European leaders. [6] Various initiatives to reduce prociclicality have also been taken by the Basel Committee on Payment and Settlement Systems, together with IOSCO by the European Commission and the Financial Stability Board[7].,

A complementary but very urgent measure would be to activate a program for interventions on the bond market. Its aim would be to preserve the liquidity of secondary bond markets in cases of major divergences of market values from fair values and to restore rather than suppress the important signaling function of financial markets. To be credible, it

[5] The source of the series on the two public finance ratios and the expected growth in real GDP, referred to a five-year horizon, is the IMF; the measures of contagion are derived from a preliminary principal component analysis. The results for 2012 are out-of-sample estimates. See M. Bufano and M. Manna (2012), “Using the math of fractals to understand the sovereign debt crisis”

[6] Another issue that is being discussed is the creation of a bond that would lead to some form of debt mutualization and which would possibly expand the supply of risk free assets.

[7] The new CPSS-IOSCO principles for financial market infrastructures and the European Market Infrastructures Regulation recommend that market participants and CPSS adopt a conservative forward looking and relative stable margin requirements in order to limit unexpected margin calls in times of market stress. The FSB and the European Commission have put forward proposals to reduce the automatic reliance on the assessments of Credit Rating Agencies.

would imply, at least at the beginning, the commitment for large purchases and sales of bonds.

Such a program would be different from traditional international bail-out programs, usually directed at countries which have lost access to the market and are unlikely to return to the market for a long time (usually at least two years). In this case the aim would be to restore market functionality, a sort of market maker of last resort. It would not imply any monetization of public debt because it would affect only the secondary market and, if necessary, could be accompanied by offsetting sterilization operations.

Recently the Governor of the Bank of Italy, Ignazio Visco alluded to the need for such programs at the Annual Meeting of the shareholders of the Bank of Italy held on May 31, 2012:

> If governments, the EU authorities, the European Central Bank itself, judge the progress of the troubled countries in financial restructuring and structural reform positively, this must be followed by a practical commitment on their part to orient markets' assessments in the same direction. The current yield spreads of government securities do not seem to take account of what has been accomplished: they fuel further imbalances, leading to a redistribution of resources from countries in difficulty to those perceived as sounder; they impede the correct operation of the single monetary policy; they are a source of risk to financial stability, an obstacle to growth[8].

The most important aspect for a scheme of this kind is the definition of conditions and enforcement mechanisms to prevent and manage moral hazard, both for borrowers and for investors[9]. The conditions (spelled out in a Memorandum of Understanding) could mirror those already defined at European level for the excessive deficit and excessive imbalance procedures. The enforcement mechanisms should envisage clear methods for monitoring compliance, and the imposition of penalties in cases of policy reversals. Responsibility for the program should therefore be assigned to a European authority with clear political power and subject to mechanisms of accountability. The actual conduct of the program could be based on a principal/agent relationship between a European institution, for instance the EFSF/ESM (principal) and the ECB (agent). The principal could also provide a guarantee

[8] Banca d'Italia, 2012, "Governor's Concluding Remarks", Ordinary Meeting of Shareholders, Rome, 31 May, p.15.

[9] The best analysis of the problems regarding the international lender of last resort function is that of Curzio Giannini, 1999 "Enemy of None but a Common Friend of All? An International Perspective on the Lender-of-last-resort Function" Essays in International Finance, Princeton.

for the agent, thereby reducing its risks. Like lending-of-last resort operations, such a program could be in place for the time strictly needed to restore market confidence.

Let me conclude. The idea that programs of this kind imply a transfer of resources from the creditor to the debtor misses the point. Obviously, the provision of liquidity implies a risk of a possible future transfer of resources but, first, this risk can be mitigated by appropriate ex ante and ex post supervision; second, it could be negligible compared with the loss of resources that would derive, even for creditor countries, if a liquidity crisis turned into a systemic crisis; and, third, if the market perceives it as a quantum leap towards more effective European governance the program could result in a win win solution for all.

Figure 1

5-year sovereign benchmarks
(per cent, daily data)

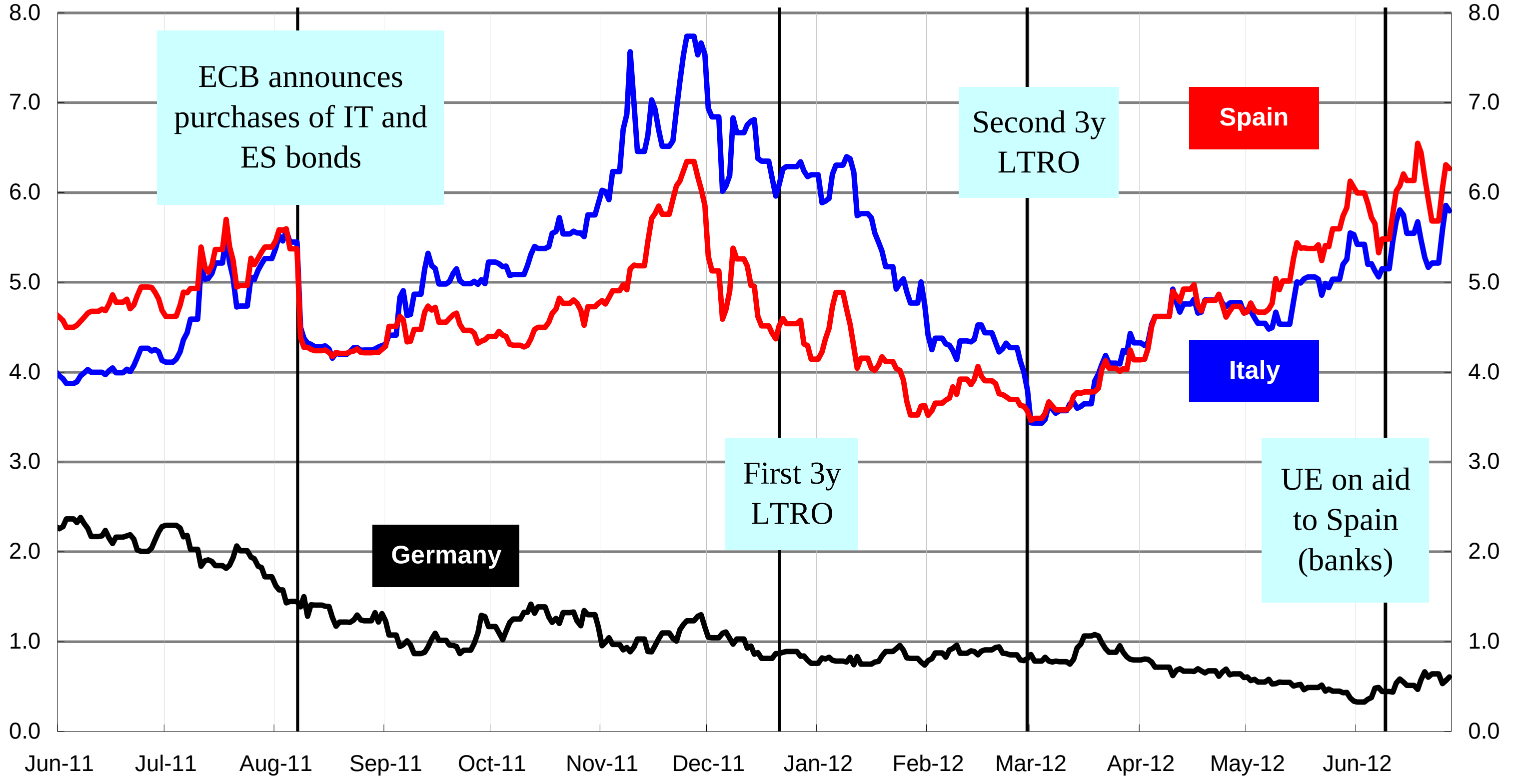
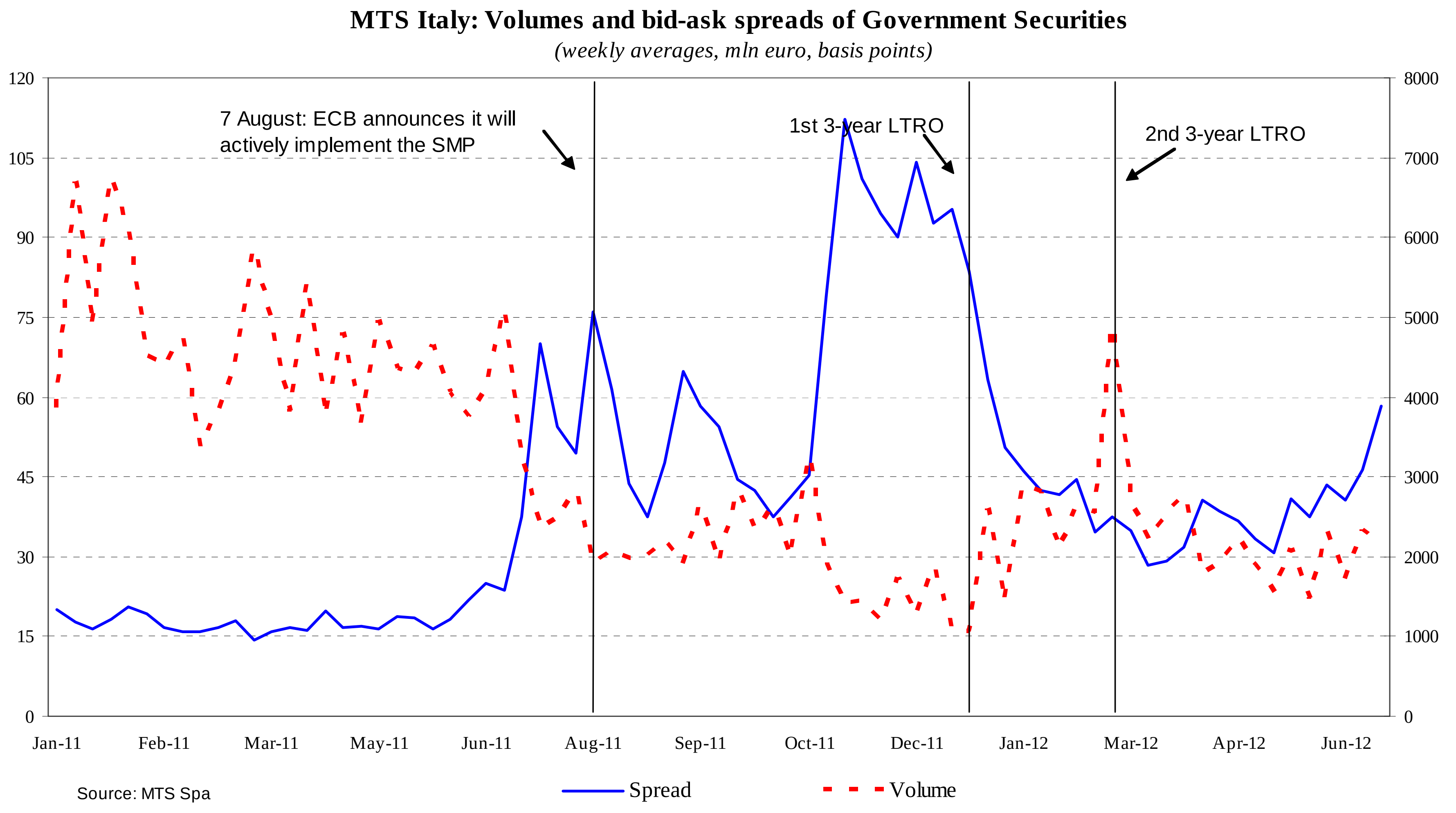


Figure 2



MTS Italy: Volumes and bid-ask spreads of Government Securities
(weekly averages, mln euro, basis points)
7 August: ECB announces it will actively implement the SMP
1st 3-year LTRO
2nd 3-year LTRO
120
105
90
75
60
45
30
15
0
8000
7000
6000
5000
4000
3000
2000
1000
0
Jan-11
Feb-11
Mar-11
May-11
Jun-11
Aug-11
Sep-11
Oct-11
Dec-11
Jan-12
Mar-12
Apr-12
Jun-12
Source: MTS Spa
Spread
Volume

Figure 3

Money market spreads

(EONIA versus overnight rate on e-MID; Eurepo tom next versus tom next rate on PCT GC; daily data; basis points)

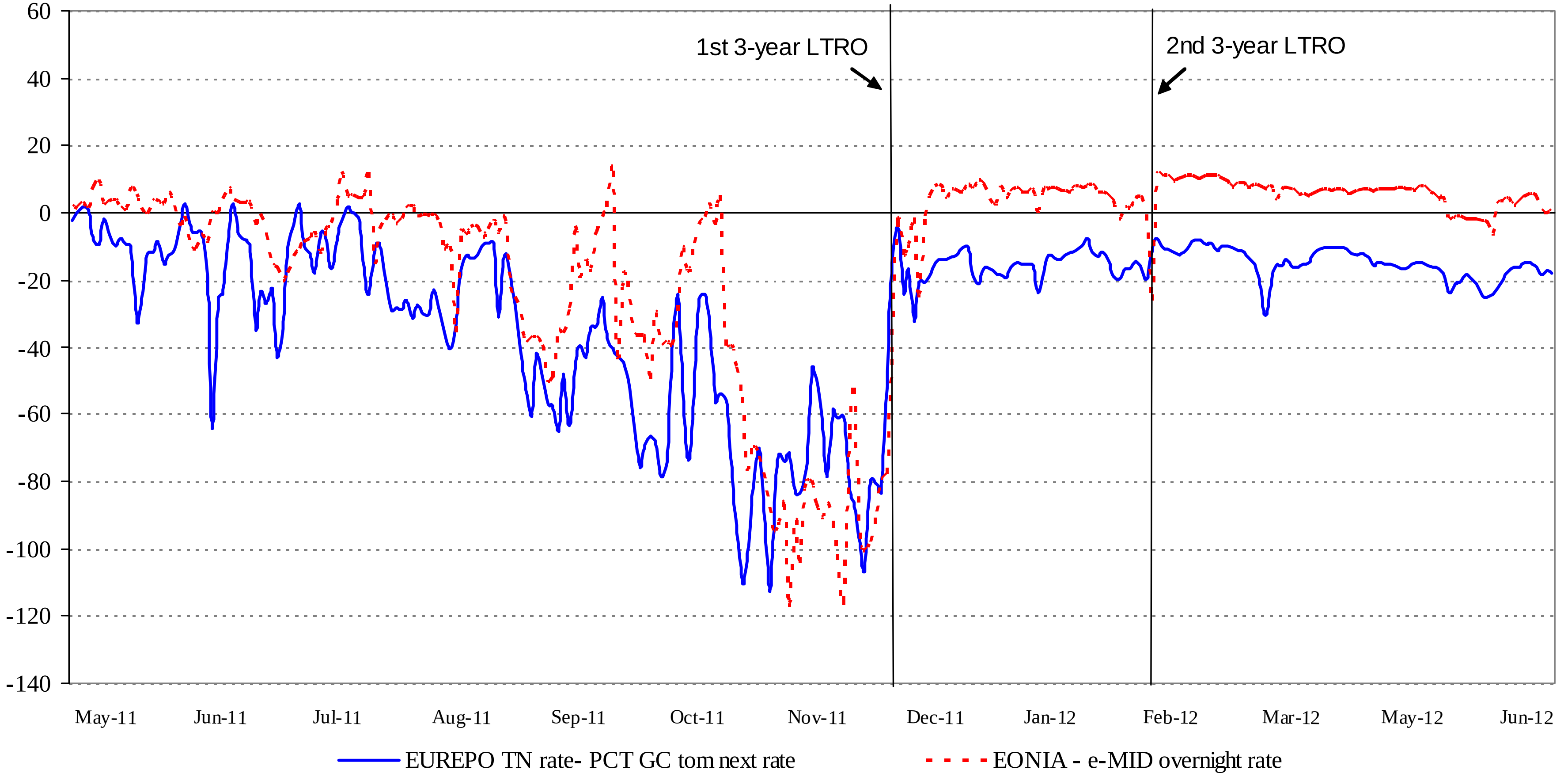


Figure 4

BTP-Bund spread: actual yields vs. fitted values of a panel model

(basis points; measures referred to October 1st of each year)