Walking on tightropes

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BOND BUYING – CAN IT DO ANY GOOD?

Example: Buying of (BTPs) Italy since 7 August 2011

10-year BTP yield (Italy government), %

Source: Bloomberg, SG

➔ Almost 6% outstanding of BTPs SPGBs owned by ESCB

SO WHY DID THE BUYING NOT WORK FOR BTPS ?

- More buying ⟶ price goes up
- More buying ➔ nature of product changes ➔ price falls

Why would the nature of the product change?

1) Supplier feared to have less incentive to maintain product quality

➔ **moral hazard**

2) The new buyer is large and powerful

➔ **subordination** (fear that the authorities risk using muscle at a later date**)**

3) Price is above perceived fair value; easy substitutes

➔ **crowding out**

Subordination: governments affirm pari passu, but they

1) introduce PSI on Greece 2) plan for ESM 3) are accompanied by IMF (de facto senior)

THE NEWSFLOW TERRIFIES POTENTIAL BUYERS

crowding out

IMF warns US of global debt 'shock'
Posted on 30. Jun, 2011 |

public power

Jul 06 2011
'Selective Default' Need Not Derail Greek Rescue

uncertainty

Sep 19 2011
ECB's Weidmann Says EFSF Doesn't Necessarily Need AAA Rating

subordination

5 Oct 2011 – **IMF** offers support to **Italy**, **Spain**. by Associated ... Borges also said the **IMF** could give the two countries **precautionary credit lines**. He said "we ...

moral hazard

October 21, 2011
again delays economic reform package

NO NEED FOR ECON 101 TO FIGURE LATEST ESCB BUYING WOULDN'T WORK

- After the experience with GGBs, IRISH and PGBs, there was no need to figure out that bond buying would not be the panacea.

➔ So how did governments manage to still persuade the ECB to embark on yet more purchases of government debt?

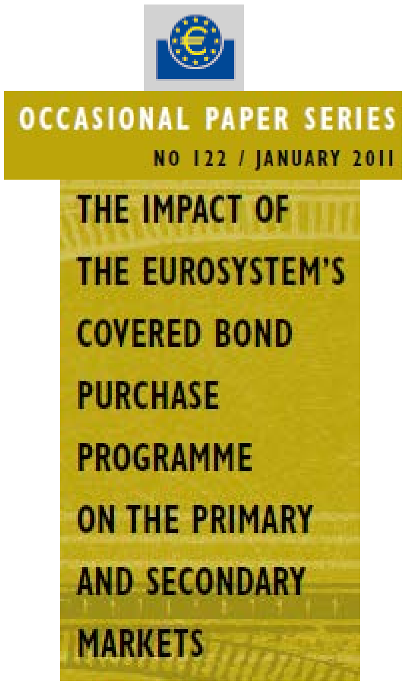
Maybe...

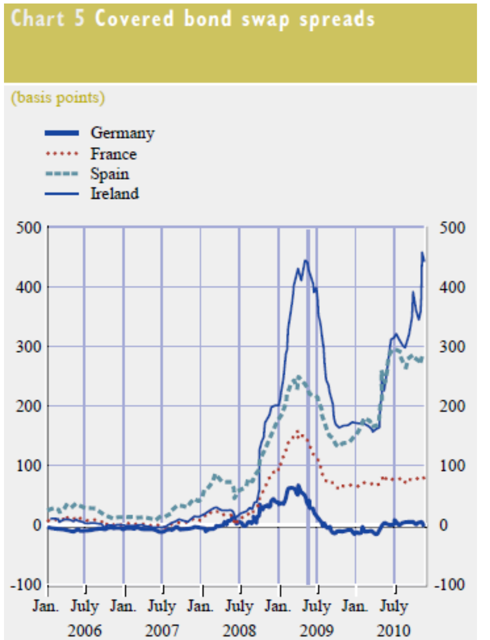
- Some wanted to a bit more time, again, before facing up to the hard decisions

And longer term

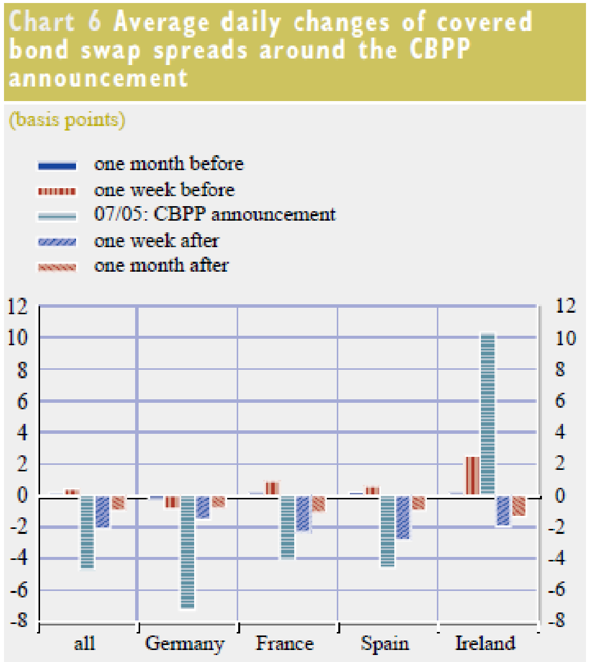
- Inability to face up to the painful political decisions, and drop in living standards, from more durable solutions
- Institutional momentum; "the institutions are there, let's use them"
- Belief that public interventions can fix the problems

Eurosystem’s Covered Bond Purchase Programme in 2009 worked a charm





The vertical line marks the announcement of the CBPP.



$$dy_{1,t} = \beta_1 \cdot dy_{2,t} + \beta_2 \cdot (y_{1,t\text{-}1} - \beta_0 - \beta_1 \cdot y_{2,t\text{-}1}) + \varepsilon_t$$

This suggests that, along the lines of the rational expectations hypothesis, the introduction of the programme alone had a significant and full impact on prices, while the purchases were only seen as the execution of the previously announced commitment.

WHAT HELPS MAKE FOR A SUCCESSFUL BUY PROGRAMME?

- Underlying fundamentals of issuer seen as remaining sound
- Credit quality of the purchased securities does not undergo deterioration

(risks of moral hazard not dominant)

- Buying addresses liquidity injection (Fed, BoE) or liquidity, less solvency
- Accompanied by other coherent policies (macro, regulatory…)

And in addition...

- Securities held for long periods, or to maturity
- Purchases large relative to new issuance

(in case ESCB's CBBP, the €60bn programme was small vs outstandings ➔ no subordination)

- Purchased amount fixed in advance, for fixed time frame

The 2009 CBBP led to a large increase in supply, making the supply / demand price moves more difficult to interpret

WALKING ON TIGHTROPES

- Possible exits from the sovereign crises:

1. Austerity

2. Inflation / QE

3. Forms of default

And less likely…

4. Fiscal transfers, from the spendthrift to the big spenders

5. Unexpectedly strong growth

Bond buying per se is not on the list, though could be part of Quantum Easing

The West will remain in crisis as long as trajectories for public finances are seen as out of control, against a backdrop of steadily worsening demographics, heightened competition & change, and greater structural difficulties in making the needed adjustments.

➔ Ever stronger risk of permanent stagnation / decline for Europe, like Japan, without strong leadership, and taking upfront pain for much longer term gain.

➔ The path of least painful adjustments probably involves walking several ropes : austerity, “Quantum QE”, forms of default, fiscal transfers …

The art would be in getting the vision, leadership, coordination and implementation right.

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