“Government bonds: Unsafe assets?” Introductory presentation

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Introduction

- **Government bond market is core component of financial system: Safe asset, and price discovery for risk-free rates – recently also bank funding (repo) and active hedge fund trading**
- **Inherently fragile because bond trading is often bilateral, outside exchanges**
- **Dealer-run market => market functioning depends on Dealer capacity**
- **This presentation:**
  - **Background on government bond market liquidity and functioning**
  - **Main themes for today**

1 Bond market functioning in US/EU: Theory vs practice (1)

1. Safe asset = very low credit risk (“information-insensitive”)

- Dash for cash: Risk-off mode = bond price down
- Falling convenience yield and rising CDS spreads as indicators of changed pricing of government bonds?

➢ No longer providing “risk-free rate”?

2. Robust market liquidity driven by resilient intermediation

- Market liquidity is very sensitive to volatility & depends on Dealer conditions
- GFC regulatory reforms, e.g. US SLR have reduced bank Dealer capacity
- Non-bank dealers expand rapidly, but only limited warehousing capacity

➢ Multiple stress episodes requiring central banks to step in

1 Bond market functioning in US/EU: Theory vs practice (2)

3. Efficient and resilient market infrastructure

- Fragmented trading across many platforms (including voice) and high share of bilaterally cleared trades (cash / repos)
- Slow progress in effective publication of trade details (TRACE & Consol. Tape)
- Similar asset = similar price: Integration of cash, repo, futures & CDS

➢ Significant settlement, liquidity and operational risks

4. Diversified and stable investor base

➢ High share of "Fast money": Increasing use of government bond as speculative instrument (Bond vs futures arbitrage ~ US$ 1 TRN)

5. Smooth sovereign funding driven by sound fiscal policy

➢ Huge growth in US/EU sovereign borrowing overwhelming market capacity?

2 *Main themes for today*

I. **Properties of safe assets**

II. **Market liquidity and role of Dealers**

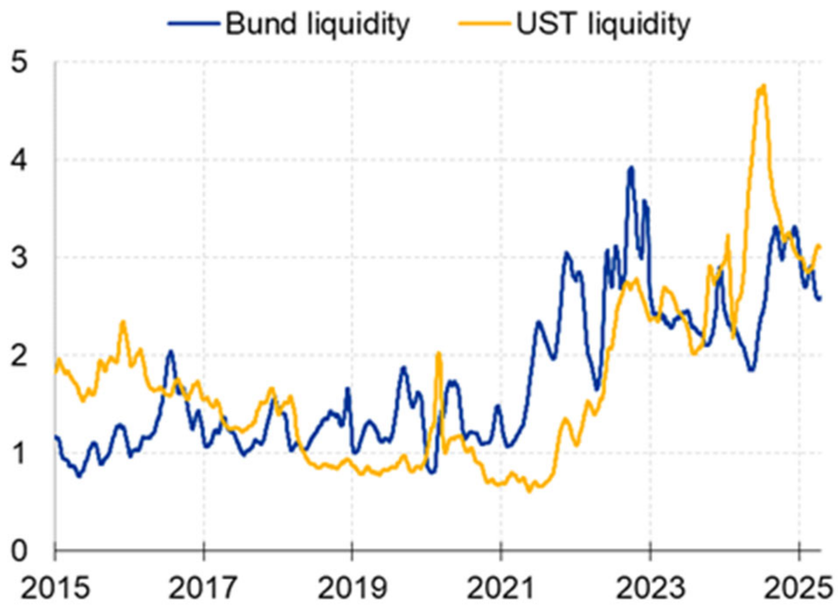
III. **Optimal infrastructure for trading and clearing of bonds & repos**

IV. **Transparency**

V. **Central Bank policy**

VI. **Fiscal policy ("elephant in the room")**

Trends in Market Liquidity



Source: Yield curve error index from Bloomberg, ECB staff calculations.

ANNEX

Decentralised bond trading: Requires Dealer to link buyer & seller

	GOVERNEMENT BOND	EQUITY MARKET
Supply	Rising (funding for climate, military etc)	Declining (-120 Bn in Q1 2024)
Transaction pattern	Few trades of large size	Many trades of small size
Intermediation	Dealer-Dealer & Dealer-Client	All to all
Trading algorithm	Quote by dealer	Limit order by investor
High Frequency Trading	No (except US-T benchmark bonds)	Yes (very active)
Clearing	Bilateral	**C**entral **C**ounter**p**arty
Fragility of Market LIQ	**HIGH (relies on Dealer Banks)**	**LOW**

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Liquidity in fixed income markets under stress

- **On-the-run** Treasuries (Notional < 5%): Daily Volume ~ $ 400 BN with bid-ask spread < 1 BP and Non-bank Dealer market share ~ 60 %;
- **Off the run Treasuries** (older bonds; Notional > 95%): Daily Volume ~ $ 150 BN with bid-ask spread > 10 BP and bank-centric
- US Treasury dislocation in March 2020: Stress in "world's safe asset"
  - Many forced sellers of Treasuries as only asset which can be sold in crisis
  - But few buyers: Rise in Dealers' balance sheet costs has reduced their warehousing capacity
  - **Fed = "Dealer of last resort"**
- Gilt dislocation in September 2022
  - **Mini-budget = fiscal policy shock**
  - **Fed = "Dealer of last resort"**

Further reading

Bank of England (2023) “Financial stability buy & sell tools: A gilt market case study” Quarterly Bulletin.

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