Jens Thomsen: Government bond markets in 2009

Speech by Mr Jens Thomsen, Member of the Board of Governors of the National Bank of Denmark and Chairman of the Economic and Financial Committee, Sub-Committee on EU Government Bonds and Bills Markets,[1] at the European Government Bond Summit, Brussels, 5 November 2009.

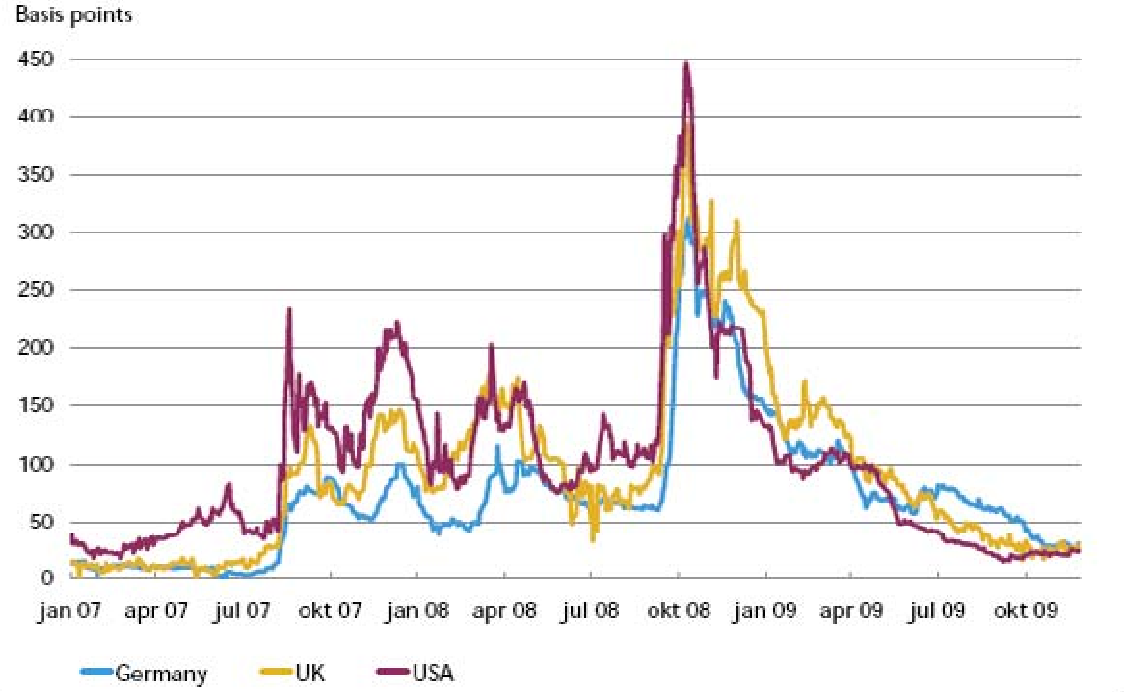
*   *   *

1. Introduction

I am delighted to be here tonight to offer my view on the development in the financial markets. A little more than a year ago the financial markets were frozen and there was a well-founded concern regarding the financial and economic outlook. 2009 has indeed proven to be challenging in many ways.

In the period after Lehman Brothers collapse the international financial crisis escalated. As a consequence the spread between uncollateralised and collateralised money-market interest rates tripled, cf. Chart 1. Most countries launched extensive rescue packages to mitigate the crisis. The interventions stopped the free fall of the financial system.

3-MONTH MONEY MARKET SPREADS IN GERMANY, UK AND USA   Chart 1



Source: Bloomberg.

Against the backdrop of weaker economic outlook governments introduced fiscal stimulus and monetary policies have been relaxed substantially. Central banks have reduced the policy interest rate sharply and provided extensive liquidity to banks and resorted to unconventional tools to ease monetary policy, which has supported financial stability.

[1] The mandate of the sub-committee is to aim at promoting further the integration and better functioning of EU government bonds and bills markets thereby impacting positively on the financial markets as a whole.

2. Government finances

The global economic prospects were gloomy at the beginning of the year and the financial crisis has had greater real economic repercussions than expected, which triggered the adoption of large stimulus packages worldwide. As a result of lower government revenue and rapidly rising expenses, public finances have deteriorated. In the course of 2009 most countries have revised their forecast of government deficits to record highs and government finances are expected to be under extensive pressure in the coming years. Government debt issuance in the euro zone is expected to be around 925 billion euro in 2009, which is an increase of around 30 per cent. In 2010, issuance is expected to be even higher.

At the same time the role of DMOs has changed as a result of the financial crisis. The special status of government securities as risk-free assets has been highlighted, and DMOs played a key role in connection with the financing of rescue packages.

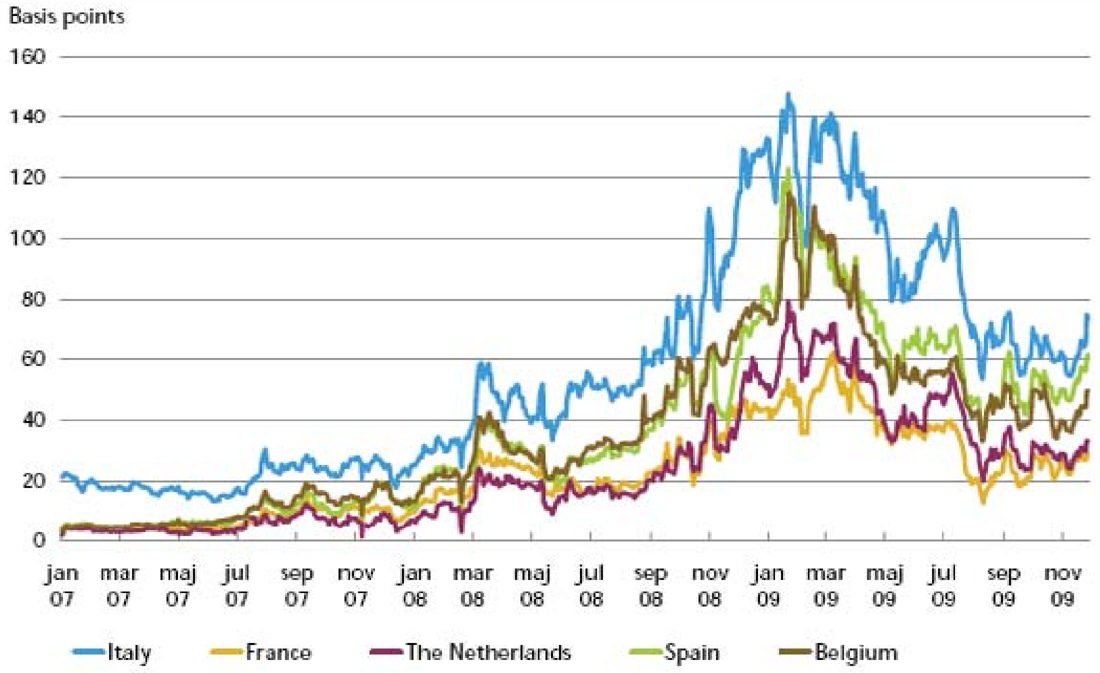
3. Government bond markets

Primary markets

The primary markets have worked reasonably well in light of the severity of the financial and economic crisis. The uncertainty in the financial markets, coupled with risk aversion among investors, led to rising demand for risk-free assets, including government bonds. Even so, the greater supply of government bonds has in periods caused investors to be more selective and some DMOs have found it difficult to obtain sufficient demand at auctions and when issuing syndicated loans. Especially in the latter part of 2008 and the beginning of 2009, DMOs paid a concession premium in order to attract investors.

In addition, yield spreads to Germany widened considerably in a number of European countries, cf. Chart 2. This reflected a flight-to-quality, as the German bond market is considered to be the most liquid in Europe. In addition, investors attributed higher credit risk premiums due to increasing concerns about fiscal sustainability in view of the rapidly growing budget. Since mid-2009 the primary markets have improved. DMOs no longer pay concession premiums and yield spreads between European countries have narrowed. The market has been able to absorb the considerable higher volume of government debt issuance better than expected.

10-YEAR YIELD SPREADS TO GERMANY Chart 2



Source: Bloomberg.

Issuance strategies

The challenging issuance climate and uncertainty about future borrowing requirements have prompted several DMOs to pursue more flexible issuance strategies. This has included issuance in government securities outside key on-the-run issues, and use of various loan programmes, including CP and EMTN programmes. DMOs have also introduced new issuance techniques to secure successful auctions. At the same time, DMOs have an increased focus on investor relations in order to avoid that investors disregard an issuer on the basis of incomplete information.

The improvement of the financial markets and lower uncertainty concerning issuance needs has meant that DMOs to a larger degree are returning to a more predictable issuance strategy.

Roll-over risk and competition from government guaranteed bonds

In the beginning of the year government deficits and financial rescue packages were primarily funded by issuing short-term papers such as T-bills and commercial papers. This raised concern about roll-over risk, especially in the light of expected high government deficits in the years to come. The concern of roll-over risk eased during the year as the gradual improvement of the government bond market enabled DMOs to lengthen the maturity profile of their issuance.

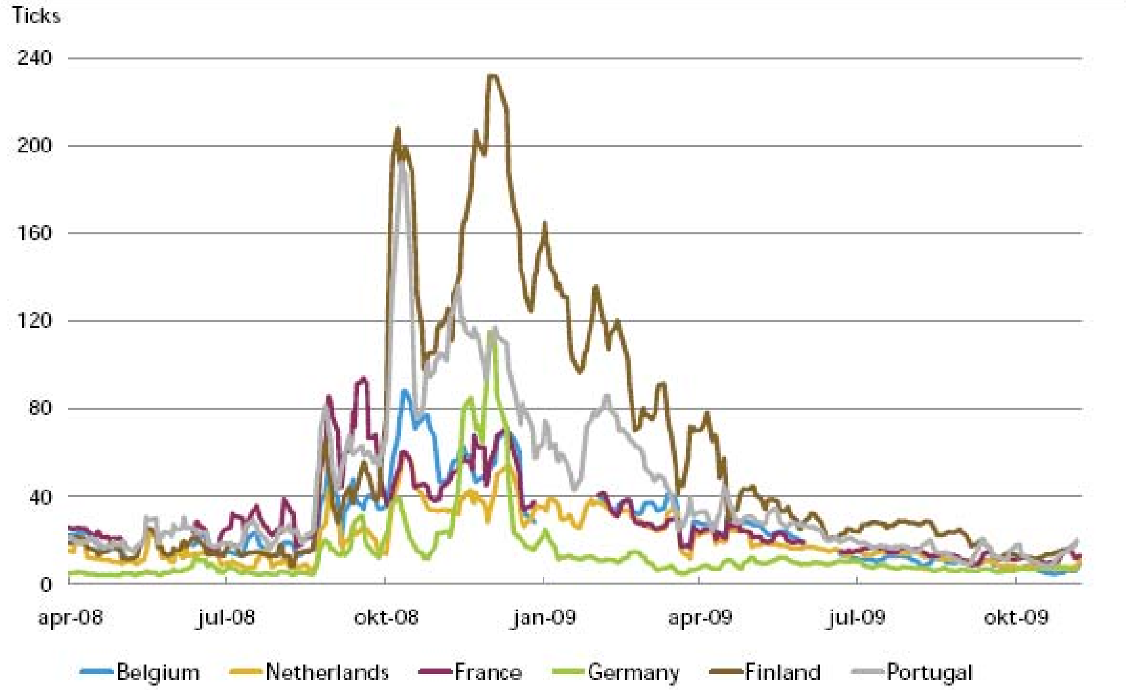
So far debt managers have by and large covered the required record issuance need for 2009 at reasonable costs. The concern in the beginning of the year regarding possible competition from government guaranteed bonds has proven to be less of an issue than expected. This can primarily be attributed to the fact that the high liquidity of government securities has a value for investors. Less liquid issuances of local governments or state agencies have to a higher degree suffered from private sector issuers with a government guarantee.

In 2010, the government bond market may see increasing competition from other sectors, including covered bonds and corporate bonds, if the financial market continues to improve and investors gain risk appetite. This would be a positive sign of health in the financial system but also raise a concern about the government bond market in view of the record issuance requirements.

Secondary markets

The secondary market has been more permanently hit by the crisis than primary markets. After the shock in September 2008, liquidity in the secondary market dried up, resulting in a significant widening of bid-ask spreads and a dramatic reduction of volumes, cf. Chart 3. The situation has improved in 2009 with a narrowing of bid-ask spreads, but the secondary markets have still not normalised. It is important to restore transparency and confidence in the government bond market. Some countries are successfully bringing more competition in the secondary market by implementing market making obligations based on relative performance among primary dealers instead of fixed maximum spreads and minimum volumes.

BID-ASK SPREADS IN 10-YEAR BENCHMARK BONDS — Chart 3

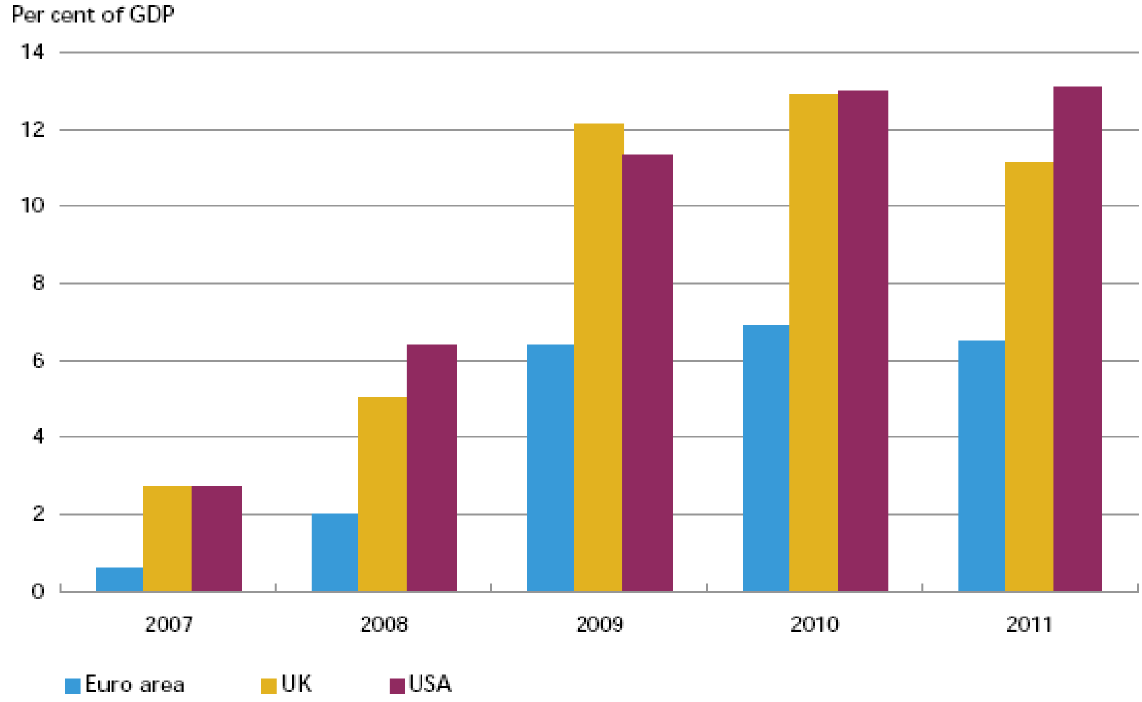


Source: MTS platforms.

Future challenges

Over the summer, the financial markets have been characterised by stronger confidence in real economic developments, and the extensive political measures have contributed to increasing the risk appetite of investors. Spreads in the money market have come down from a high of several hundred basis points to a level below pre-Lehman. Similarly, the spreads between European issuers have narrowed considerably. These factors indicate a significant improvement in financial conditions since the historical low in October 2008. The panic mood has ceased, but the enhanced market stability is to a high degree the result of continued public support measures. Market conditions have still not normalised and the estimated government issuance need for 2010 is record high in many countries due to high redemptions and large budget deficits, cf. Chart 4.

GENERAL GOVERNMENT BUDGET DEFICITS Chart 4



Source: European Commission, European Economic Forecast Autumn 2009.

Compared to one year ago, debt managers and banks are however less nervous. The financial markets have improved and in light of the expectations of the future government funding requirements turnover in the primary and secondary market should increase. Both debt managers and bankers have a mutual interest in restoring confidence in the market.