Jens Thomsen: Government bond market in light of the recent turmoil

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 Market[1], at the European Government Bond Summit, Brussels, 24 October 2008.

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Introduction

I am delighted to be here today to offer my view on the ongoing turbulence in the financial markets.

In the not so distant past the financial markets played a role by applying pressure on Member State governments to run sound public finances in Stage III of the EMU. Today the tables have been turned. A reasonable description of the present agenda is more along the lines of how the public finances can promote sound financial markets (see slide 2).

Liquidity

In turbulent times the price of liquidity increases. Since august of 2007 there has been four consecutive waves of illiquidity, during which the perceived default and liquidity risk of banks have risen and widened the spread between unsecured and secured lending and where the fourth and last spike following the default of Lehman Brothers has been the most severe (see slide 3).

The decomposed TED spread shows how T-bills have become especially valuable in times of crises (see slide 4). During the four spikes the lending against US T-bill has driven down the T-bill rate.

The same effect has not been quite as prominent in the European money market (see slide 5). The most recent flare up of the turbulence has however lead to significantly increased demand for short term government securities leading to lower interest rates for the German T-bills.

Prior to the recent turbulence in September the search for safety drove down both the T-bill and the highest rated commercial paper yield. Lately the status of the commercial paper programs as a safe heaven has eroded, as the CP-markets have frozen (see slide 6). Outstanding amounts of asset backed commercial papers took a significant dive at the outset of the turbulence in 2007 (see slide 7). Recently the outstandings of commercial papers for financial issuers have been declining. Note however that the latest data does not reflect the impact of the Commercial Paper Funding Facility (CPFF) provided by the Federal Reserve.

Credit risk and issuance terms

The increased price of liquidity has been followed by an increase in of the price of credit. The recent announcements of bank recapitalisations and guarantee schemes have curtailed the upswing in the CDS spread in the financial sector. However spreads are still high compared to pre-August 2007 levels (see slide 8). Even sovereigns have not been immune to the increased credit risk valuations (see slide 9). Following the announcement of the rescue packages, the CDS-spreads for sovereigns seem to have stabilized.

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

In relation to issuance terms in this volatile market the bond yields have been declining compared to level in July 2008 (see slide 10). This movement has primarily been driven by a flight to safety. Nevertheless the demand for government securities can be quite volatile. The latest round of financial turmoil has indeed lead to pronounced increase in the volatility both in the stock and bond market (slide 11), which from an issuers standpoint makes it difficult to manoeuvre in terms of coming out with timely issuances in such an unpredictable market environment.

In addition increased credit risk and demand for liquidity have widened the yield spread to German government securities and thereby aggravating the relative issuance terms for other EMU-countries (see slide 12). Under the assumption that the yield spread between member states purely can be explained by differences in credit risk and liquidity, one may use prices on credit default swaps (CDS) as an approximation for the credit risk premium. The liquidity risk may then be defined as the residual of the yield spread after deducting the credit risk premium (see slide 13). The calculation shows that the widened yield vis-à-vis Germany in 2008 compared to 2007 is predominately caused by increased credit risks.

The financial turbulence has elucidated the role of the government securities as safe havens (see slide 14). Under normal market conditions the swap market may function as a substitute for government securities especially in terms of it's virtues in regards to pricing. However the increasing credit and liquidity premiums imply that this type of substitution is no longer valid.

Market conditions

In general banks are under pressure. They experience rising funding costs and declining market value (see slide 15). The capacity of the balance sheet is constrained making it more difficult to handle the intermediation phase between issuers and end-investors. In addition, the constrained balance sheets combined with increased volatility have lead to widened bid offer-spreads in the secondary government bond markets, hence the efficiency of the European government bond market has temporarily gone down (see slide 16).

The role of the DMOs

After listing the areas in which the government debt management experiences the effect of the financial turbulence. I now turn to discuss in what role the DMOs may play in handling the crisis (see slide 17).

- Involvement in handling the stressed situation in the financial sector
- Help to ensure state guarantees to secure confidence between financial counterparties – and thaw up the frozen interbank market.
- Issue sufficient funds to perform the announced recapitalisations of banks.

It has been stated that the government ownership through recapitalizations should be a temporary solution. When it comes time to wind up the government ownership of the banks timing can be hard; should the government for instance sell its shares, when the share prices are high, i.e. in periods of high growth where the government typically does not have a funding need?

What lies ahead?

Ahead of us lies a period, where a majority of the governments in the Euro area will experience an increased need for funding, hence higher issuance from sovereign issuers is to be expected (see slide 18 and 19).

Changing perspectives

In 2003 the headline was:

"The role of **financial markets** in promoting sound **public finances** in EMU"

Today the perspective is turned around:

"The role of **public finances** in promoting sound **financial markets** in EMU"

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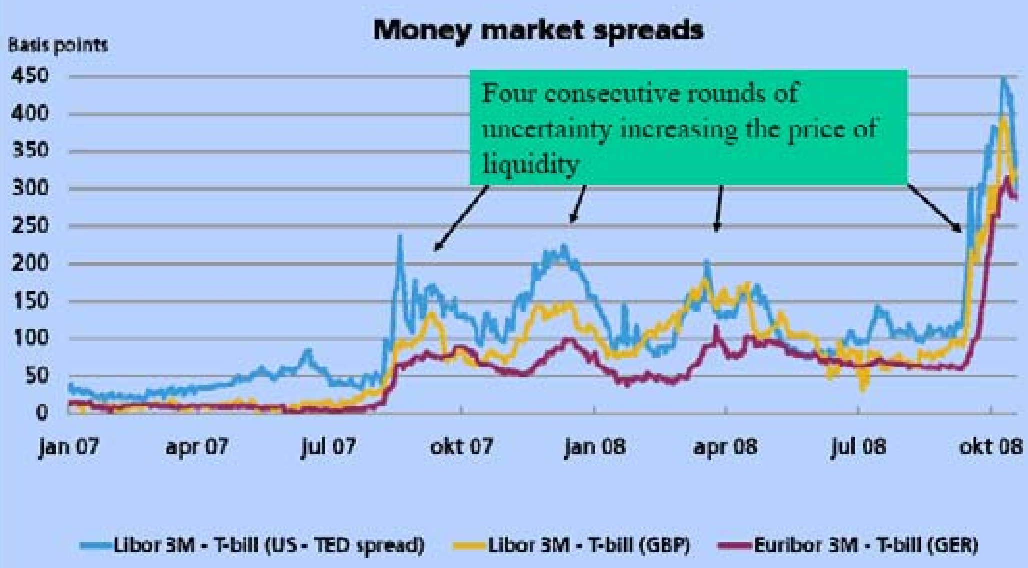
Price of liquidity in turbulent times is very volatile



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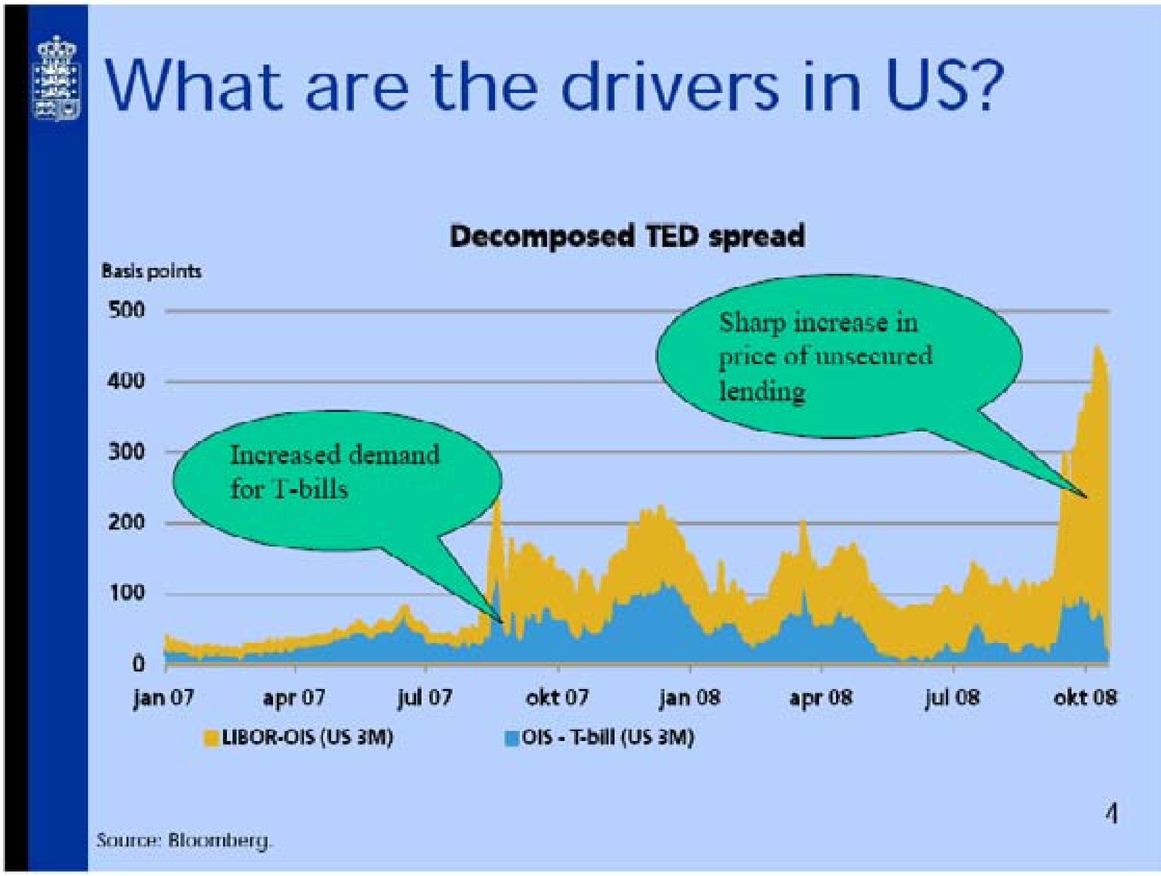
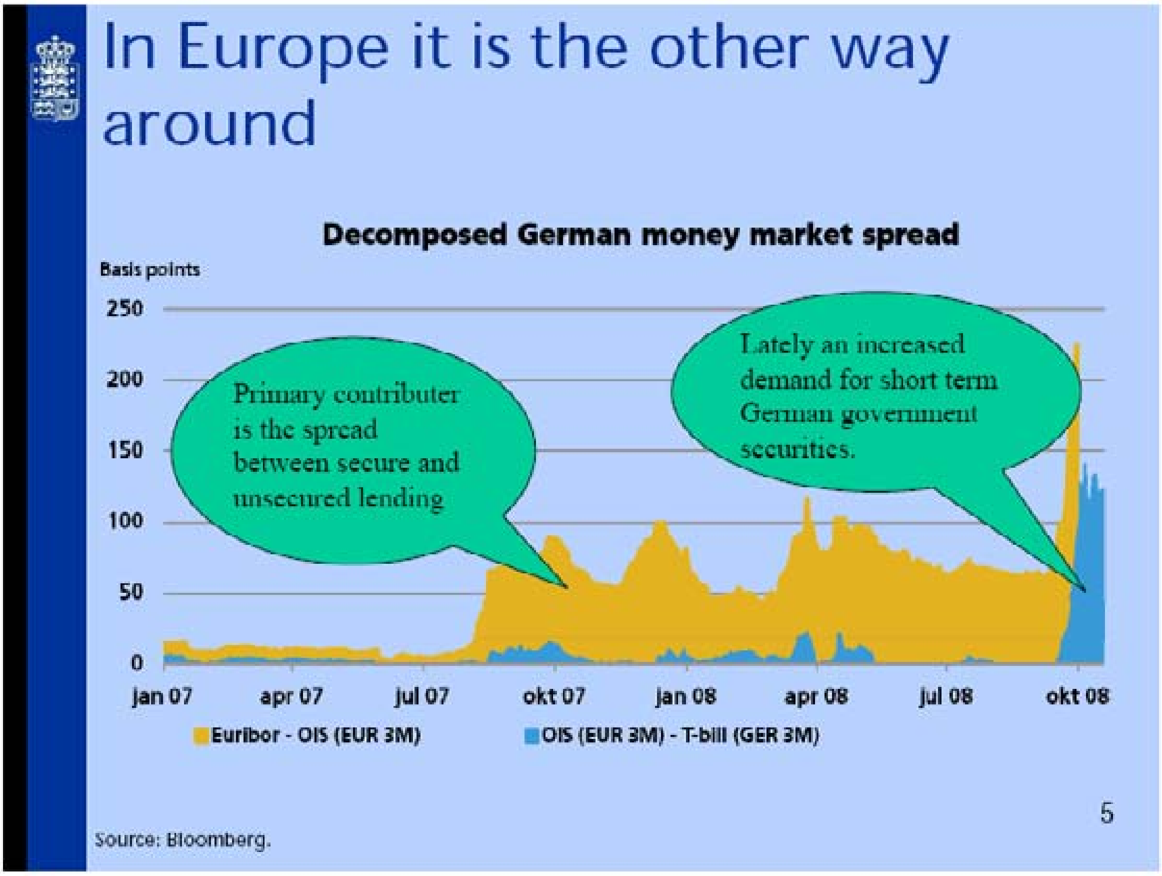
Source: Bloomberg.


What are the drivers in US?
Decomposed TED spread
Basis points
500
400
300
200
100
0
Sharp increase in price of unsecured lending
Increased demand for T-bills
jan 07
apr 07
jul 07
okt 07
jan 08
apr 08
jul 08
okt 08
LIBOR-OIS (US 3M)
OIS - T-bill (US 3M)
4
Source: Bloomberg.


In Europe it is the other way around
Decomposed German money market spread
Basis points
250
200
150
100
50
0
Primary contributer is the spread between secure and unsecured lending
Lately an increased demand for short term German government securities.
jan 07
apr 07
jul 07
okt 07
jan 08
apr 08
jul 08
okt 08
Euribor - OIS (EUR 3M)
OIS (EUR 3M) - T-bill (GER 3M)
5
Source: Bloomberg.

Turbulence leads to search for safety

Source: Bloomberg.

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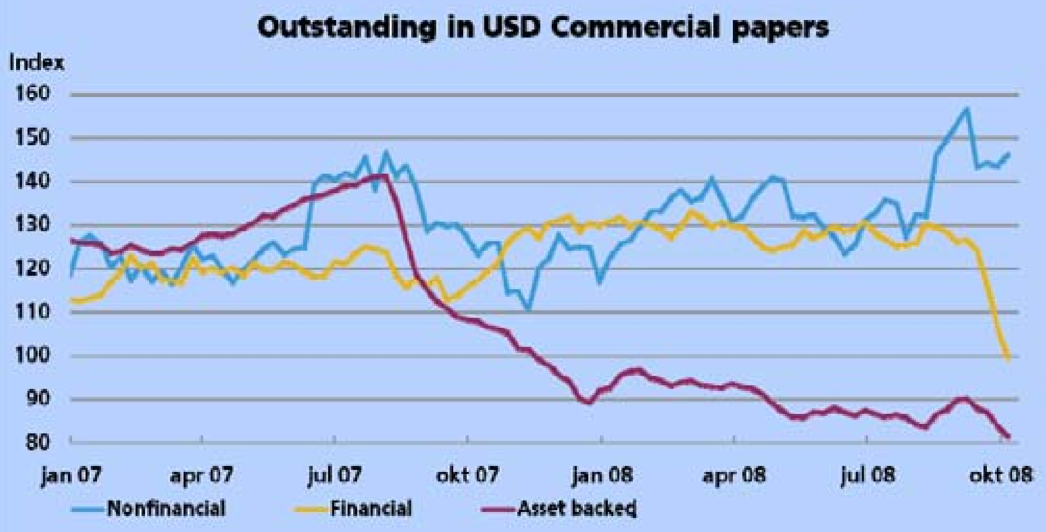
Development in US CP-market



Source: Bloomberg.

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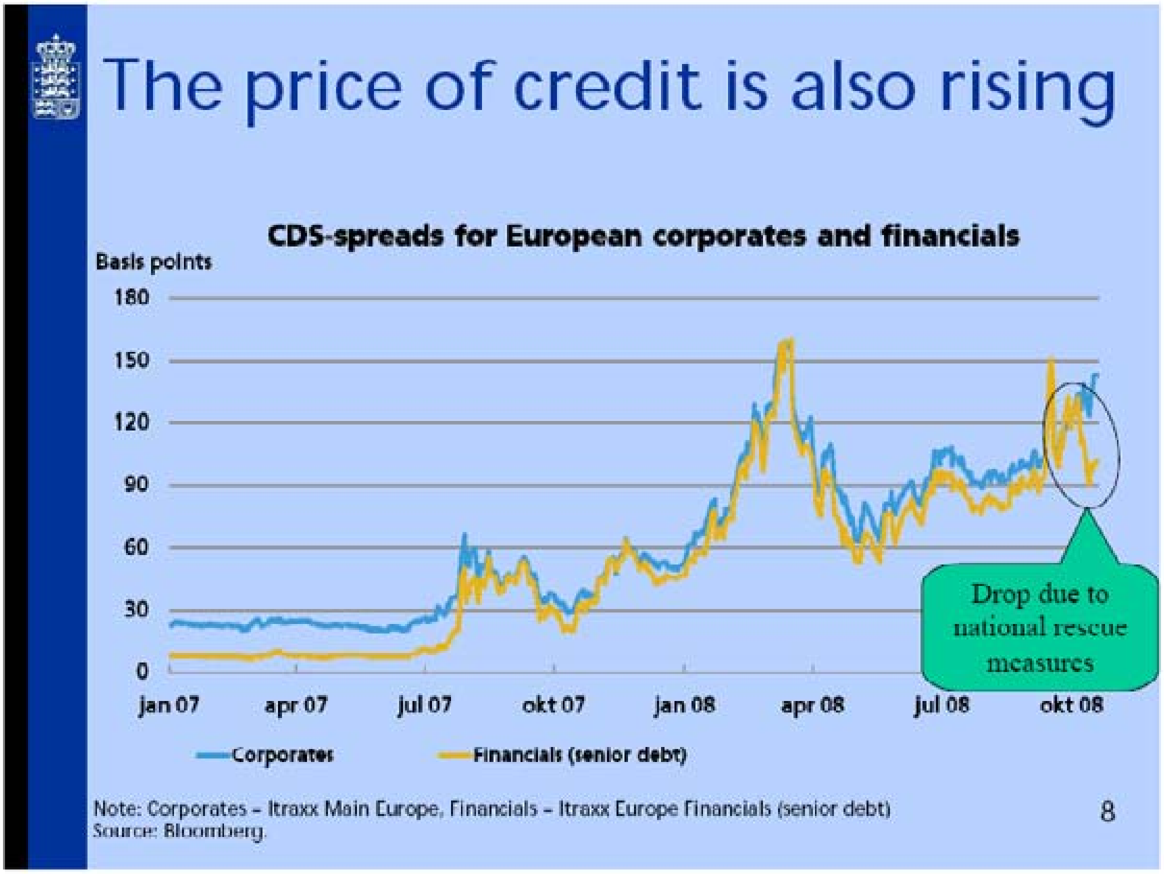
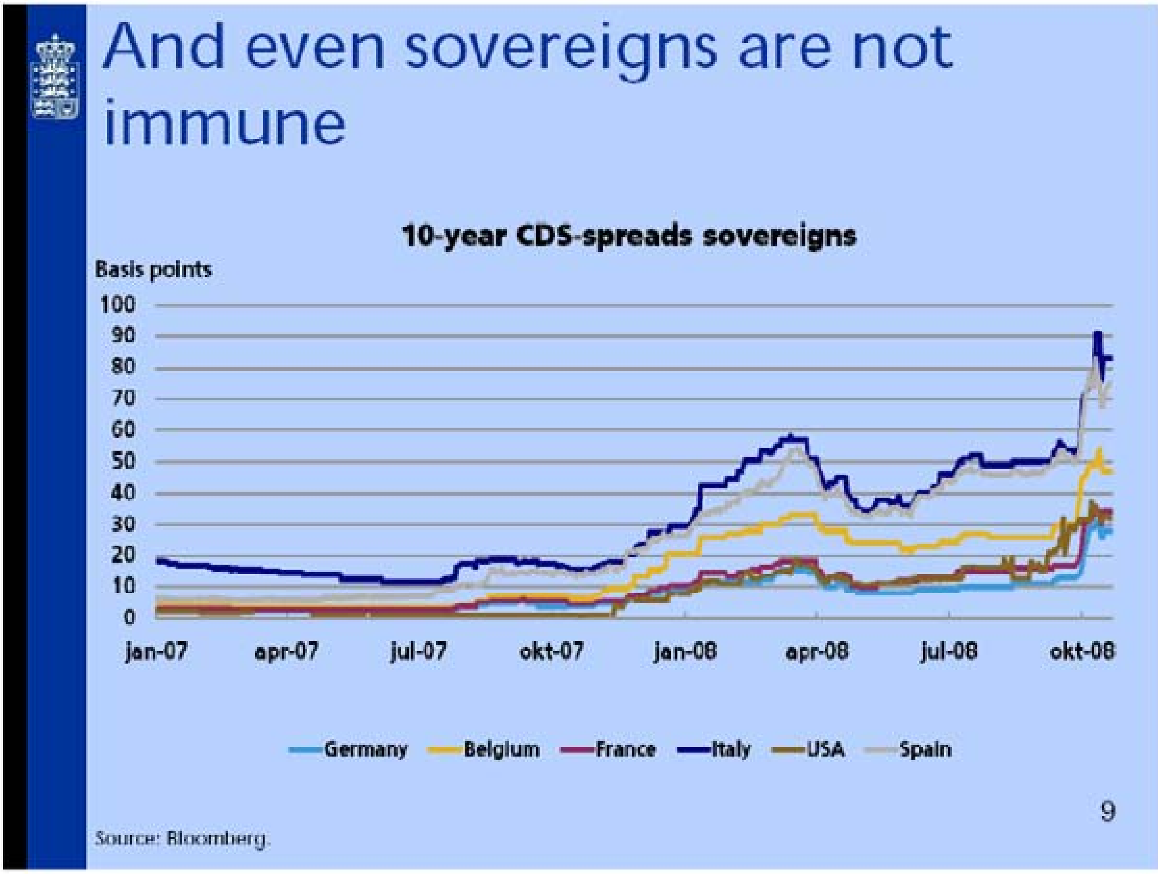
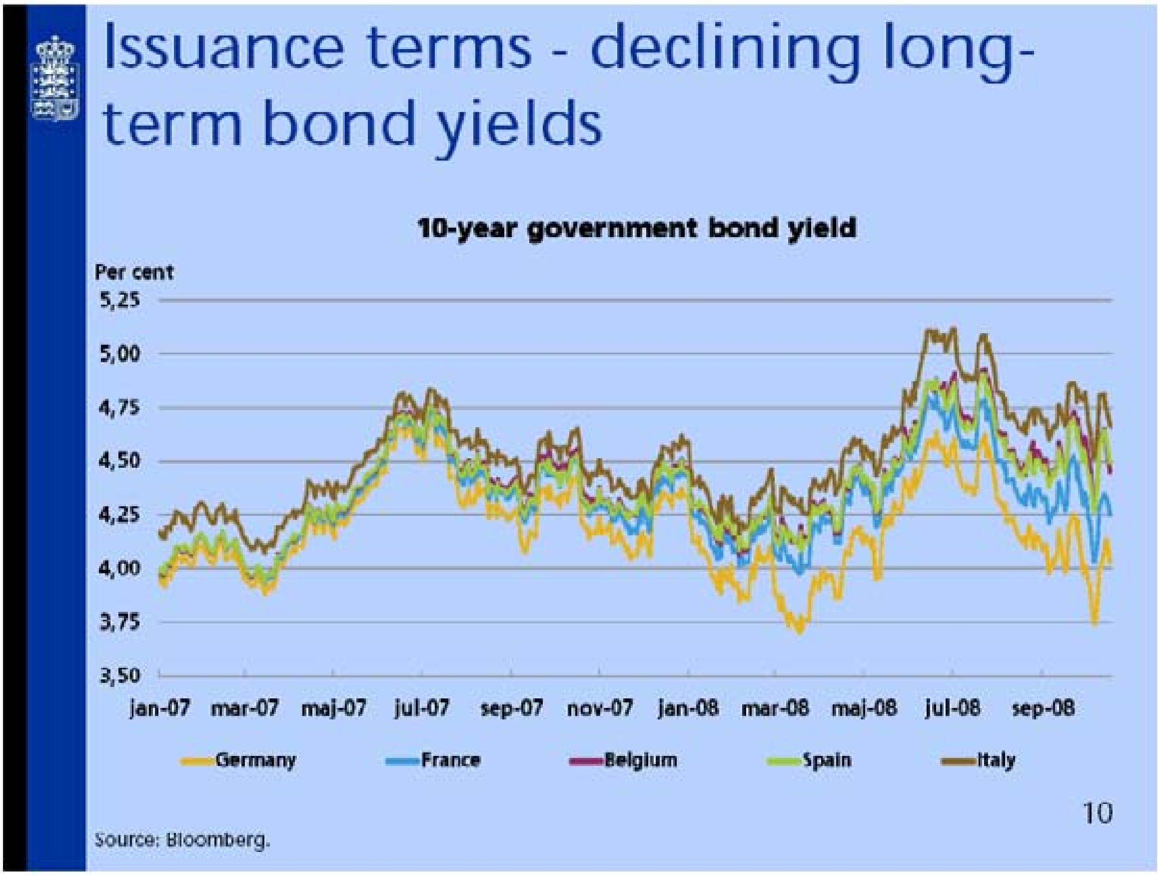
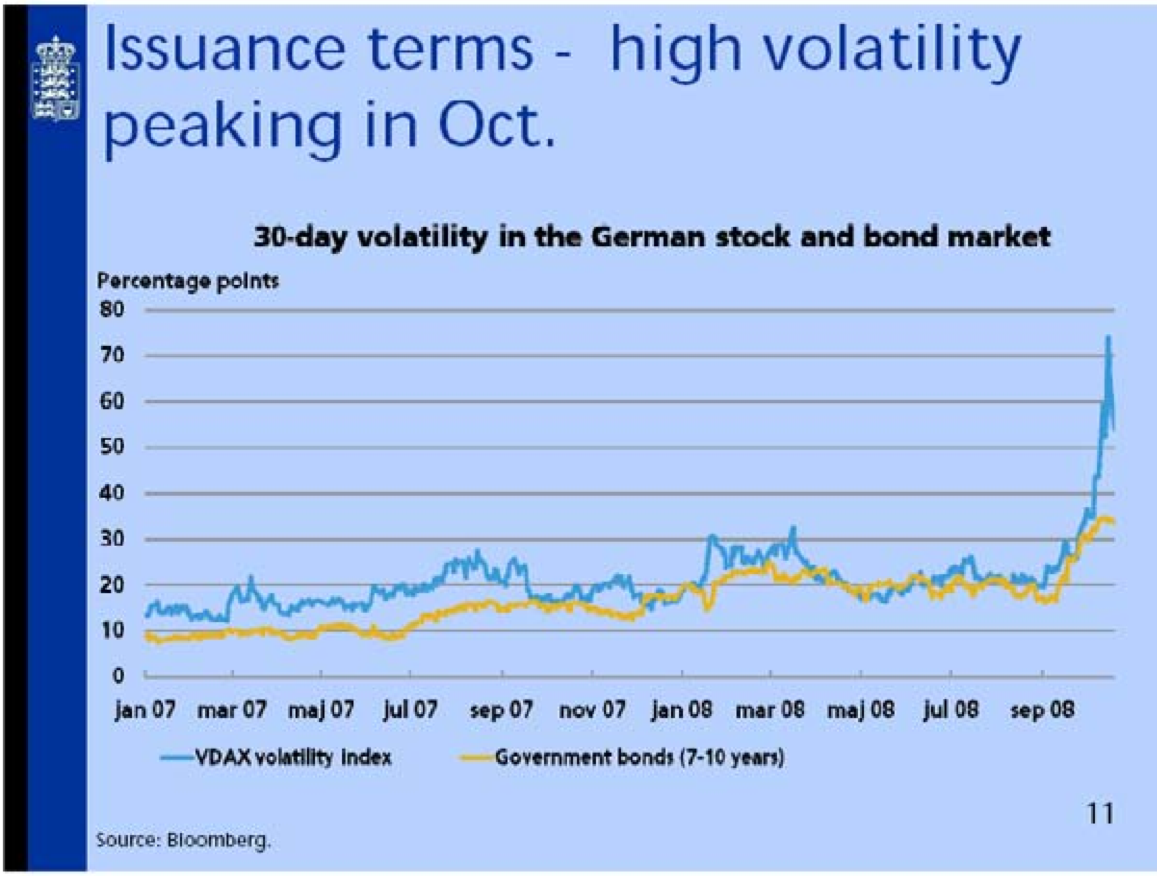


The price of credit is also rising
CDS-spreads for European corporates and financials
Basis points
180
150
120
90
60
30
0
jan 07
apr 07
jul 07
okt 07
jan 08
apr 08
jul 08
okt 08
Drop due to national rescue measures
Corporates
Financials (senior debt)
Note: Corporates – Itraxx Main Europe, Financials – Itraxx Europe Financials (senior debt)
Source: Bloomberg.
8

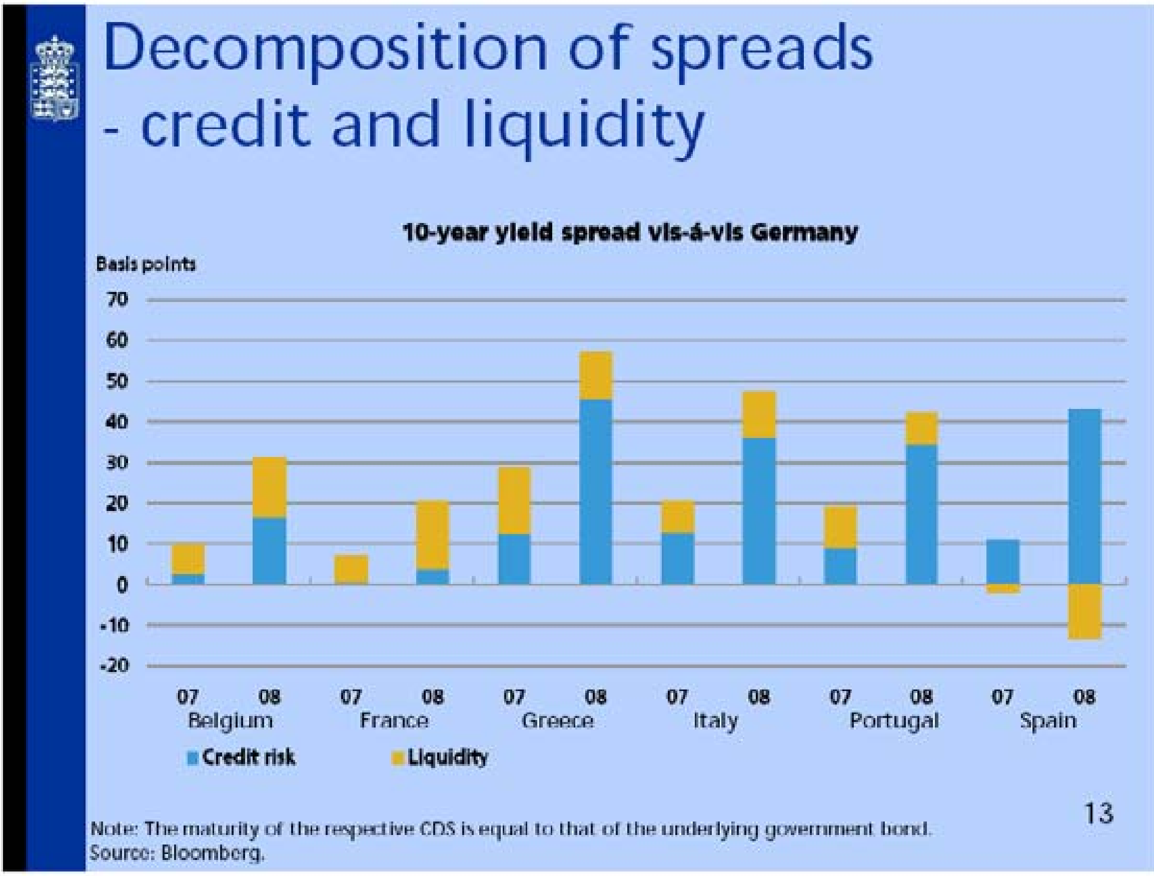


And even sovereigns are not immune
10-year CDS-spreads sovereigns
Basis points
100
90
80
70
60
50
40
30
20
10
0
jan-07
apr-07
jul-07
okt-07
jan-08
apr-08
jul-08
okt-08
Germany
Belgium
France
Italy
USA
Spain
9
Source: Bloomberg.


Issuance terms - declining long-term bond yields
10-year government bond yield
Per cent
5,25
5,00
4,75
4,50
4,25
4,00
3,75
3,50
jan-07 mar-07 maj-07 jul-07 sep-07 nov-07 jan-08 mar-08 maj-08 jul-08 sep-08
Germany
France
Belgium
Spain
Italy
10
Source: Bloomberg.


Issuance terms - high volatility peaking in Oct.
30-day volatility in the German stock and bond market
Percentage points
80
70
60
50
40
30
20
10
0
jan 07 mar 07 maj 07 jul 07 sep 07 nov 07 jan 08 mar 08 maj 08 jul 08 sep 08
VDAX volatility index
Government bonds (7-10 years)
11
Source: Bloomberg.


Widening spreads to Germany
10-year spread to Germany
Basis points
90
80
70
60
50
40
30
20
10
0
Jan 07
Mar 07
May 07
Jul 07
Sep 07
Nov 07
Jan 08
Mar 08
May 08
Jul 08
Sep 08
France
Italy
The Netherlands
Spain
Belgium
Source: Bloomberg.
12


Decomposition of spreads
- credit and liquidity
10-year yield spread vis-á-vis Germany
Basis points
70
60
50
40
30
20
10
0
-10
-20
07
08
Belgium
France
Greece
Italy
Portugal
Spain
Credit risk
Liquidity
Note: The maturity of the respective CDS is equal to that of the underlying government bond.
Source: Bloomberg.
13

Decoupling betweeen swap and government bond market

14

Source: Bloomberg.

Challenges in the intermediation phase

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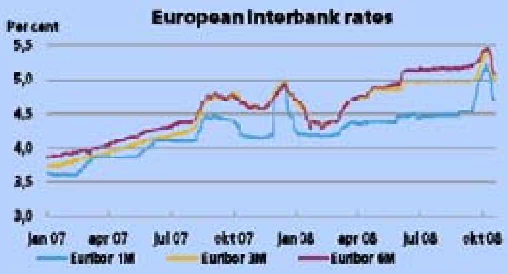
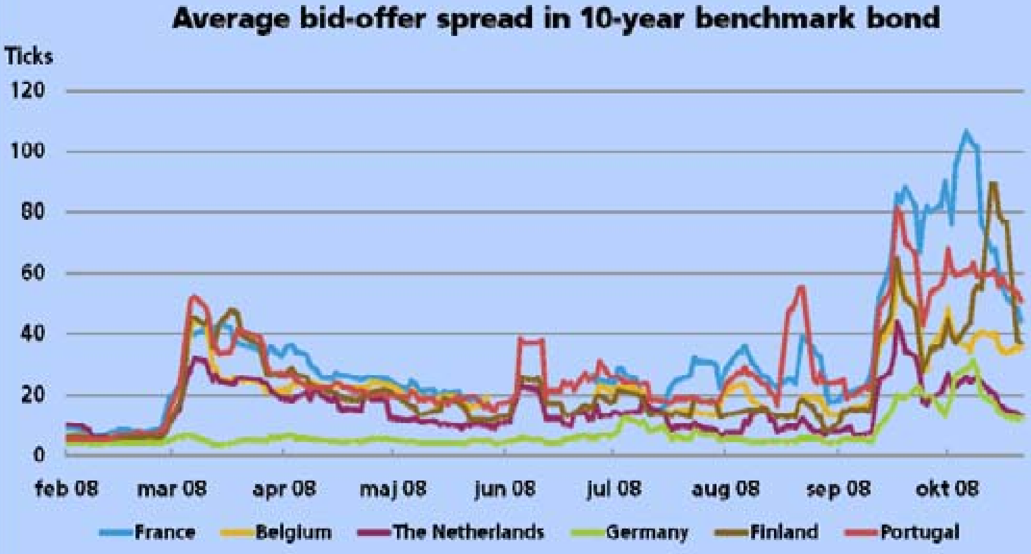
- Banks are under pressure
- Balance sheet capacity is constrained
- Making it more difficult to handle the intermediation phase between issuers and end-investors



Source: Bloomberg.

Turbulence leads to widened bid-offer spreads



Note: Five day moving averages.
Source: MTS

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What roles do the DMOs have in handling the crisis?

- **Involvement in handling the stressed situation in financial sector**
- **State guarantees to secure the confidence in the financial sector**
- **Funding of recapitalisations of banks**

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Rescue packages look to increase government security issuance

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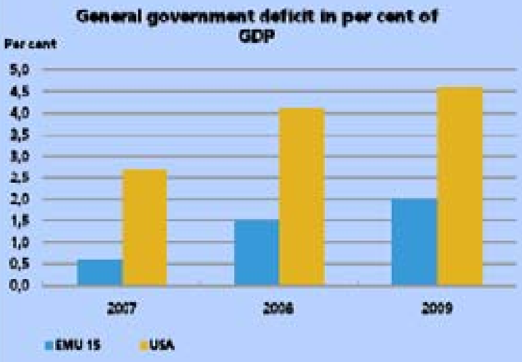

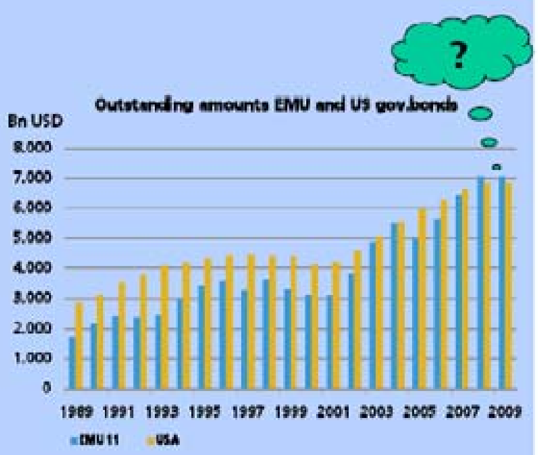

Source: BIS and IMF World Economic Outlook. October 2008

What lies ahead?

Higher issuance from sovereign issuers is to be expected

- Cheapest way to finance the debt

"A national debt, if it is not excessive, will be to us a national blessing."

Alexander Hamilton (1755-1804), American politician leading author of The Federalist Papers.

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