Secondary Market for Government Bonds: Breaking the Bank–Sovereign Nexus

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Banking crises have been followed by sovereign crises and vice-versa

- In some cases, governments took on excess debt and risks while rescuing failed banks or stimulating the economy
  - Ireland
  - United States?
From Irish banks to sovereign (Acharya, Drechsler, Schnabl 2011)
Banking crises have been followed by sovereign crises and vice-versa

- In some cases, governments took on excess debt and risks while rescuing failed banks or stimulating the economy
  - Ireland
  - United States?

- And, in yet others, private debts and growth slowdown engulfed governments too (Spain)

- And in some others, governments took on excess debt and deficits prior to the financial crises
  - Greece, Italy
  - United States?
Spain and Ireland were prudent fiscally... until banking crises

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Lessons from ongoing crises

- Governments keen to expand fiscally.
  - Easier to subsidize consumption than to sustain growth
- Governments reluctant to cut back fiscally, even in wake of mounting debt on balance-sheets.
- BUT much sovereign debt held by own banks.
- Sovereign debt used in repos/as collateral to facilitate financial transactions.
- Sovereign deterioration has “collateral damage”
Countries choose the extent of “entanglement” of financial sector with government bond markets

Example I: Government-sponsored enterprises (GSEs)
- Fannie Mae privatized in 1968
- But “agency” debt maintained special status, e.g., as OMO collateral at the Fed
- Over 50% of debt held by financial firms
- This commitment allowed agencies to borrow and stimulate housing in the United States
- Commitment was upheld ex post
Entanglement of GSE debt

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<th>Holders of GSE Debt: 4Q10</th>
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<td>Finance Sector</td>
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<td>Household sector</td>
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<td>Rest of the world</td>
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<tr>
<td>Government</td>
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- Finance Sector: 55%
- Household sector: 1%
- Rest of the world: 16%
- Government: 28%

Source: Federal Reserve, Credit Sights
Governments entangle banks...

- Myopic governments increase financial sector entanglements to borrow more
  - Example II: Financial repression in Europe (zero sovereign debt risk-weights)
  - Example III: High liquidity requirements for domestic banks (India, among others)
- Increases current debt capacity
- But with uncertainty, such entanglement also increases the future cost of failure
  - Double whammy
“Home bias” in govt bond holdings of the European financial sector

Source: Acharya, Drechsler and Schnabl (2011)
Summary

- Strong nexus of government debt and banks leads to financial fragility
  - Banking crisis $\Rightarrow$ Difficult for sovereign to issue
  - Sovereign credit deterioration $\Rightarrow$ Collateral damage for the banking sector
- Instead of government debt markets being an antidote to banking crisis, and banks being an antidote to sovereign crisis, the two amplify each other’s problems
- Constitutional debt/deficit limits might be valuable if the problem is excess government spending and bank–sovereign nexus
Alternative: Secondary market?

- A secondary debt market with government debt held by a range of financial institutions can help break government–bank nexus
- Secondary market may be essential for non-banking institutions to hold substantial portions of debt
  - Trading-based, fast-moving demand for debt
- Conversely, non-banking institutions with fast-moving demand crucial for liquidity of the secondary market
Breaking the nexus

- In case of a banking crisis, investors would allocate funds away from banks to the government bonds
  - Money market funds invested in government debt
  - Other institutions holding government debt
- Impairment of banking sector would not impair the government bond market
- Indeed, the government may experience a flight to safety and can fiscally stimulate if necessary
- Conversely, a credit deterioration of the government need not impair banks substantially as government debt also held by other FI’s
Flight to government debt in banking crisis: Acharya–Mora 2010

Figure 3a. Assets under management in money market mutual funds

Source: iMoneyNet for money market mutual funds (MMMFs), weekly data.
Case of India: Flight to SBI & PSBs (Acharya–Kulkarni 2010, RBI)
How to develop secondary bond market: Reduce the role of banks

- Banks currently hold over 50% of GOI debt
  - This is partly due to high liquidity requirements
  - This is also due to lack of institutional depth
Holding pattern of GoI debt–2011 (MoF)

- Banks and Bank-PDs – 51%
- Insurance Companies + PFs + MFs– 32%
- FIIIs – 1%
- Corporates – 1.6%
- RBI and others – 14%
Holding pattern of Gol debt–2011 (MoF)
How to develop secondary bond market: Reduce the role of banks

- Banks currently hold over 50% of GOI debt
  - This is partly due to high liquidity requirements
  - This is also due to lack of institutional depth
- India faces a chicken-and-egg problem
  - Markets won’t develop with such bank presence
  - Banks irreplaceable till markets develop
- A focused effort to develop secondary trading in government (and corporate/infra) debt
- Japan, a case of caution: Banks own 45% of government debt; recession could be a double whammy?