NATIXIS

FLASH ECONOMICS
ECONOMIC RESEARCH

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It would be far better if market discipline functioned

Market discipline does not function: risk premia (on sovereign bonds, bank and agency bonds, structured products, and also on bank loans) are far too low before crises and far too high after crises; they do not correctly rank the risks of the various issuers.

If market discipline does not function, it must be replaced by central bank interventions (purchases of bonds whose risk premia are too high), which creates moral hazards and monetary risks; by regulations (on banks' debt leverage and more generally on their balance sheet structure, and therefore on their lending capacity), which may have perverse effects (credit crunch); or by macroeconomic rules (control of fiscal and external deficits) which are inevitably simplistic.

It would be far more effective if market discipline functioned: borrowers would be encouraged to reduce their debt, investors would have a clear view of the ranking of risks, and there would be no need for ex post ***monetisation of excessive debts.***

ECONOMIC RESEARCH
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Market discipline does not function

Market discipline is the ability of financial markets - and bank credit markets - to set reasonable risk premia. But it is clear that market discipline does not function. Let us look at:

- **euro-zone sovereign bonds (Chart 1A);**
- **bank bonds (Charts 1B** and **C);**
- **agencies in the United States (Chart 1D);**
- **structured products (Chart 1E);**
- **interest rate margins on bank loans (Charts 1F** and **G).**

Chart 1A
10-year yield spread against Germany

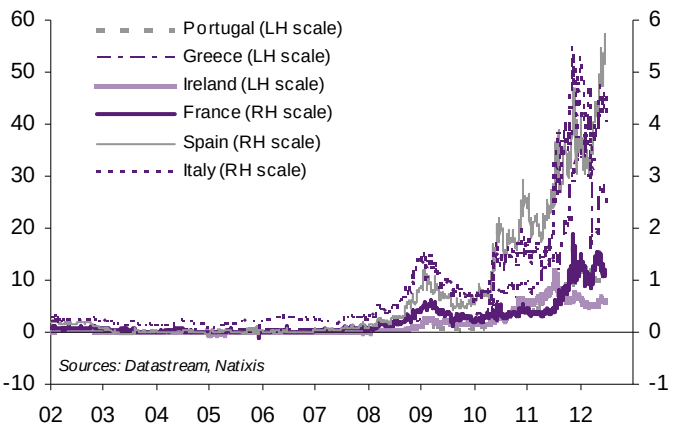


Chart 1B
Bank CDS (5-year, in bp)

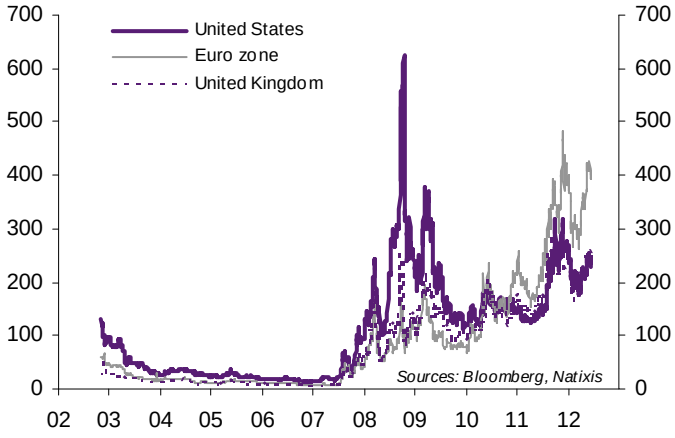


Chart 1C
Covered bond spread against swaps (in bp)

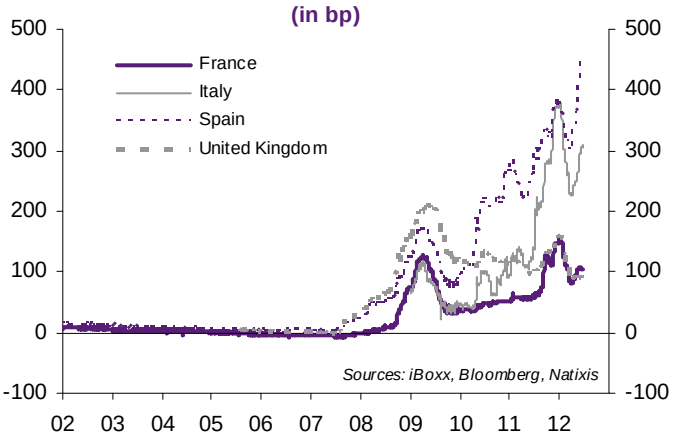


Chart 1D
Agency bond spreads against swaps (in bp)

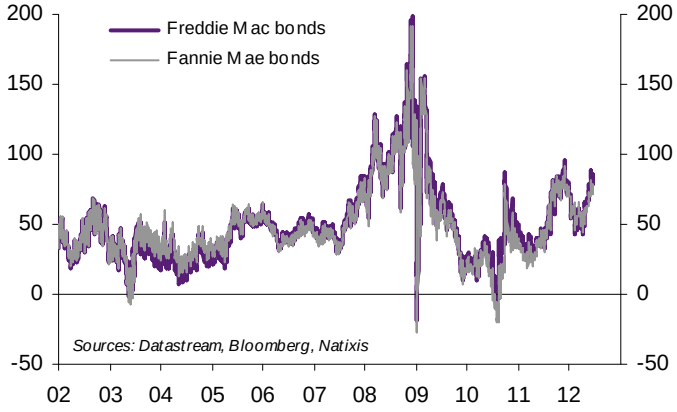


Chart 1E
United States: Spreads against swaps (in bp)

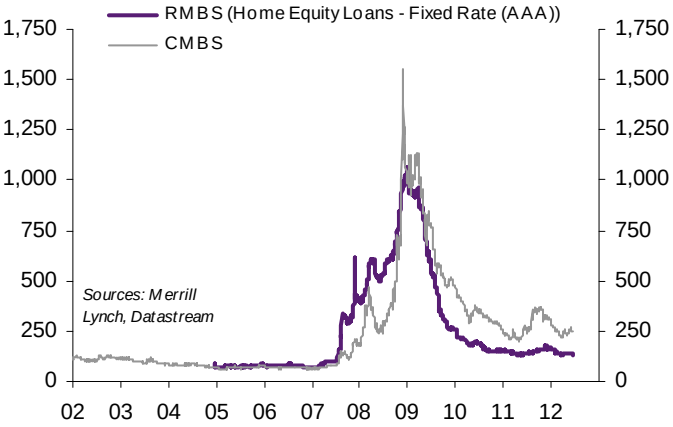


Chart 1F
Interest rate margin on loans to households

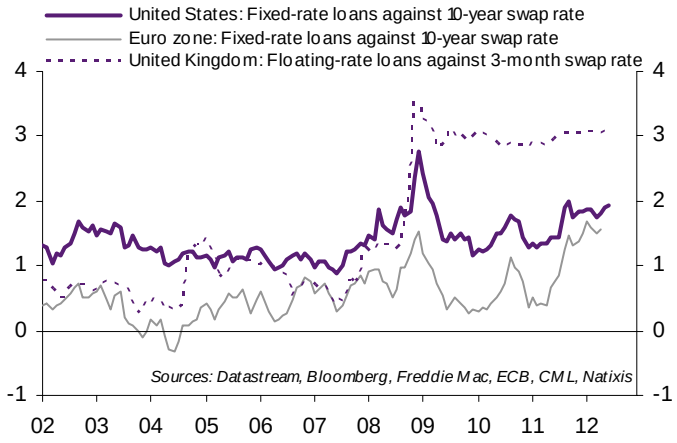
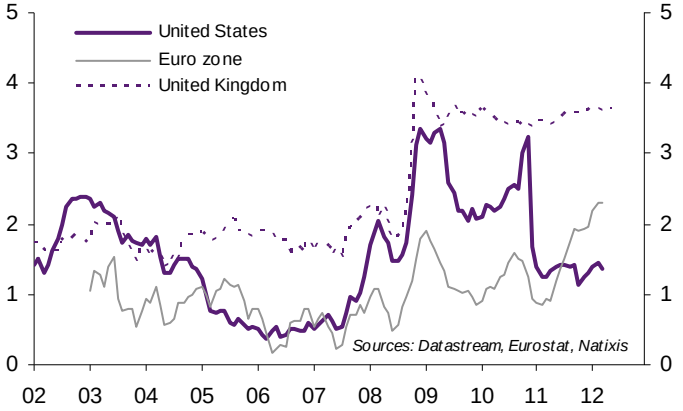


Chart 1G
Interest rate margin on business loans against swaps



We can see that, on all these assets:

(1) Risk premia were far too low prior to the 2008 crisis; in particular, all euro-zone countries raised funding at more or less the same interest rates; interest rate margins on loans certainly did not reflect the risk of defaults during a recession **(Charts 2A** and **B).**

Chart 2A
Household defaults

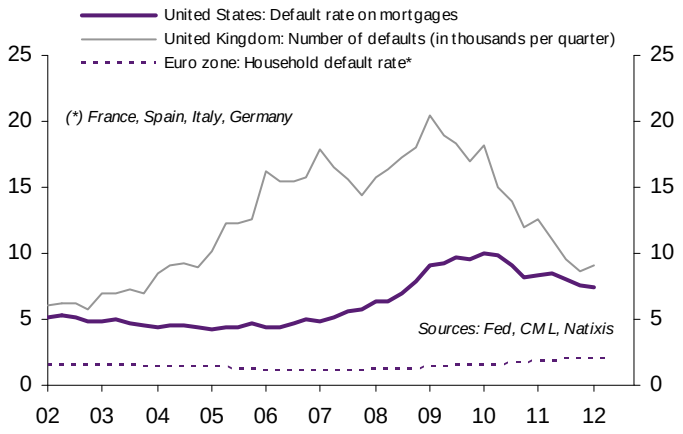
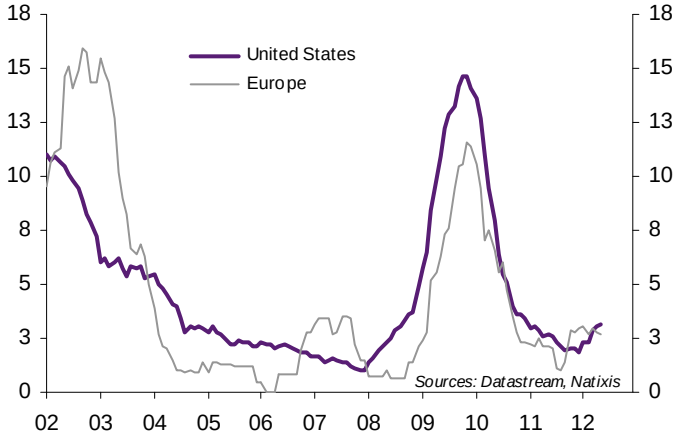


Chart 2B
High-yield default rate



(2) Risk premia have become far too high in the wake of the crisis, to the point **that they are choking off the economies** of the troubled countries. **Charts 3A** and **B** show for example the extremely high level of interest rates relative to the growth rate in Spain and Italy, with a contagion of the risk premia from the public sector to the risk premia of banks and companies **(Charts 4A** and **B).**

Chart 3A
Spain: Nominal GDP and interest rate on 10-year government bonds

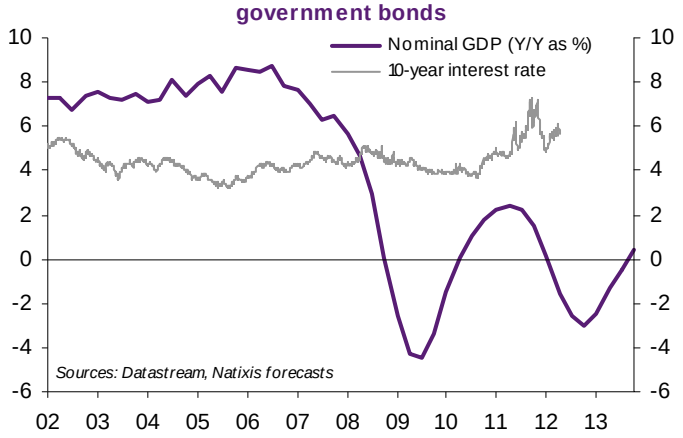


Chart 3B
Italy: Nominal GDP and interest rate on 10-year government bonds

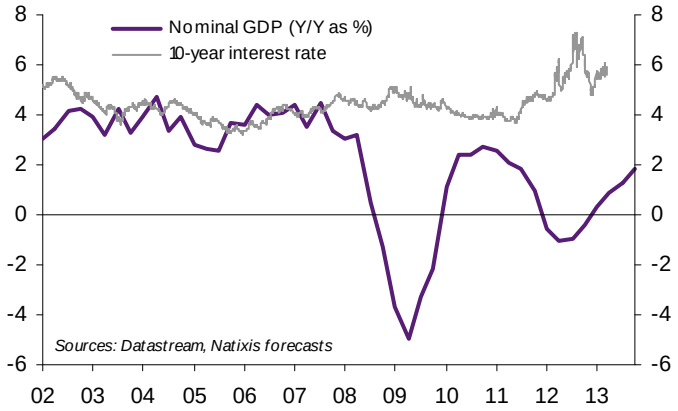


Chart 4A
Spain: CDS (5-year, bp)

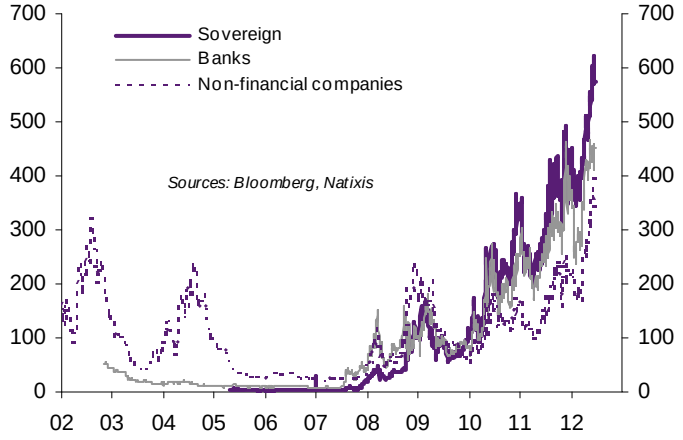
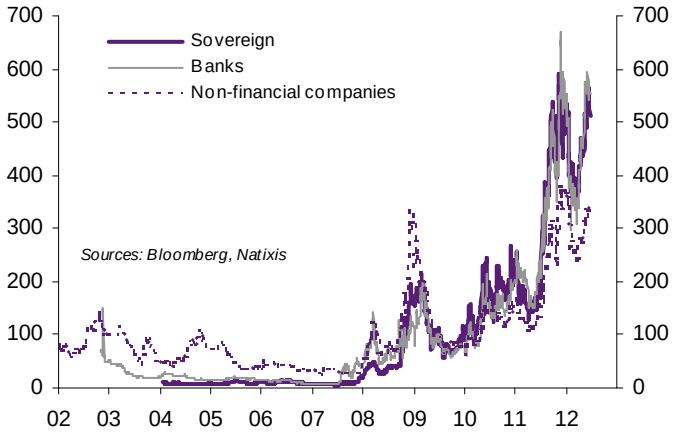


Chart 4B
Italy: CDS (5-year, bp)



(3) The ranking of risk premia does not correspond to the ranking of risks. This can be seen for example from a comparison of **Spain and Italy.** Long-term interest rates are highly correlated **(Chart 5A)**, yet Italy, in comparison with Spain, has a large-scale industry **(Chart 5B)**, trade surpluses **(Chart 5C)** and healthy public finances **(Chart 5D).**

Chart 5A
Interest rate on 10-year government bonds

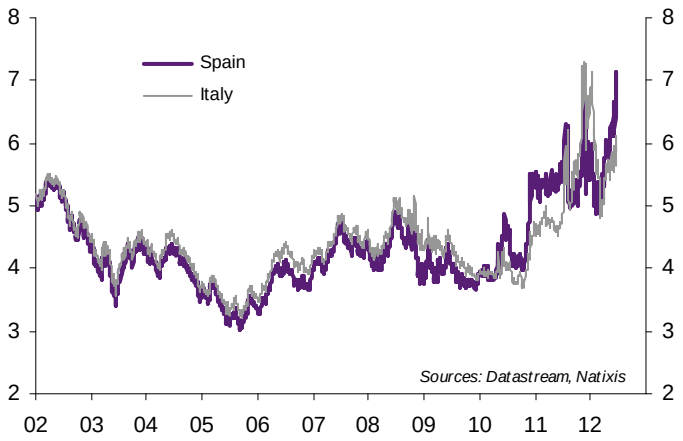


Chart 5B
Employment in the manufacturing sector (as % of total employment)

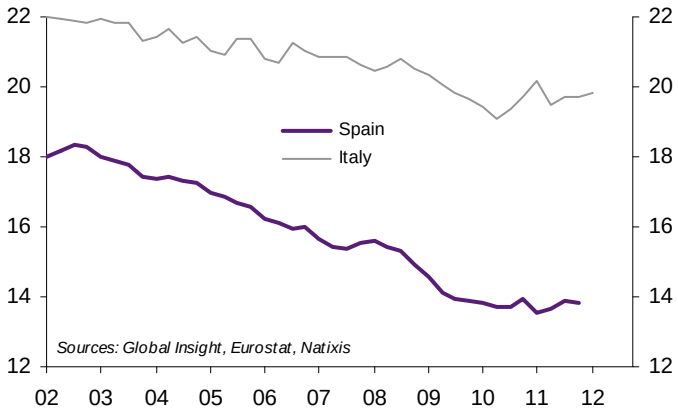


Chart 5C
Trade balance (in EUR bn, annualised)

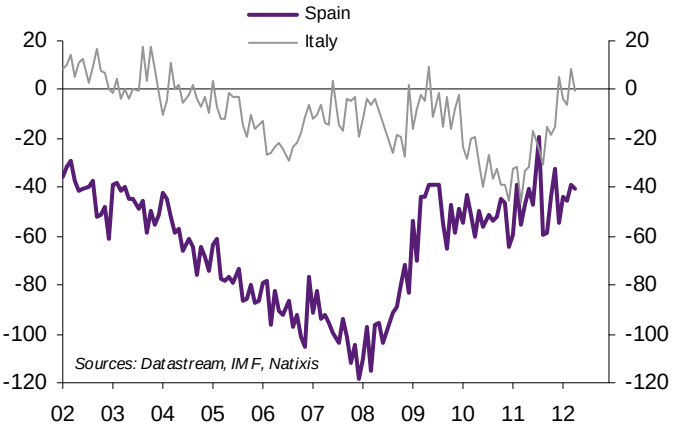
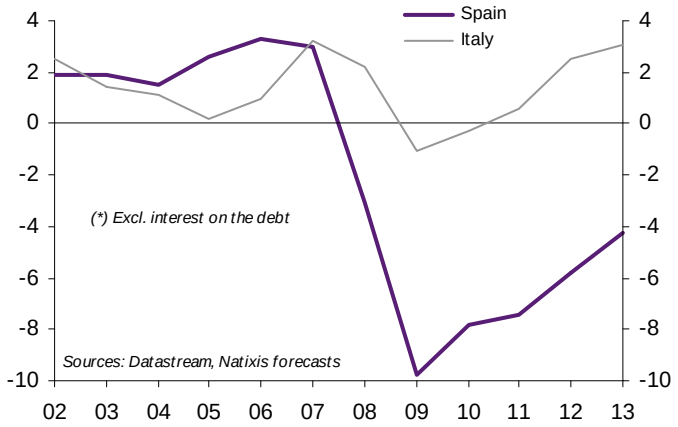


Chart 5D
Primary fiscal deficit* (as % of GDP)



What can market discipline be replaced with?

(1) **First, without market discipline, risk premia are abnormally low before crises. This leads to an excessive increase in the indebtedness of the private sector (Chart 6A), public sector** in a few countries (Greece for example, **Chart 6B**) and **the financial sector (Chart 6C) in all countries (Chart 6D).**

Chart 6A
Private sector debt load* (as % of nominal GDP)

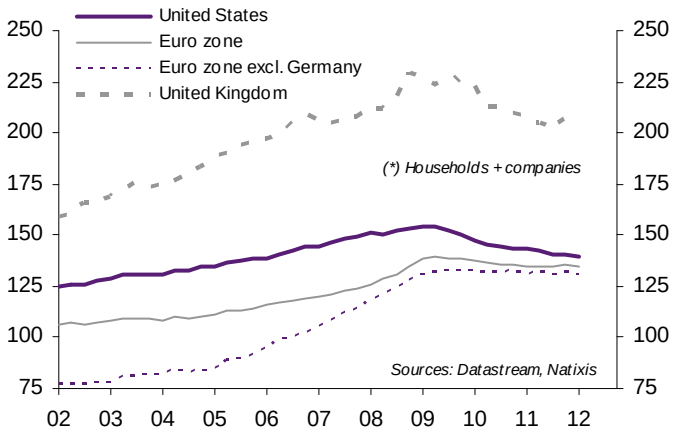


Chart 6B
Greece: Public debt (as % of GDP)

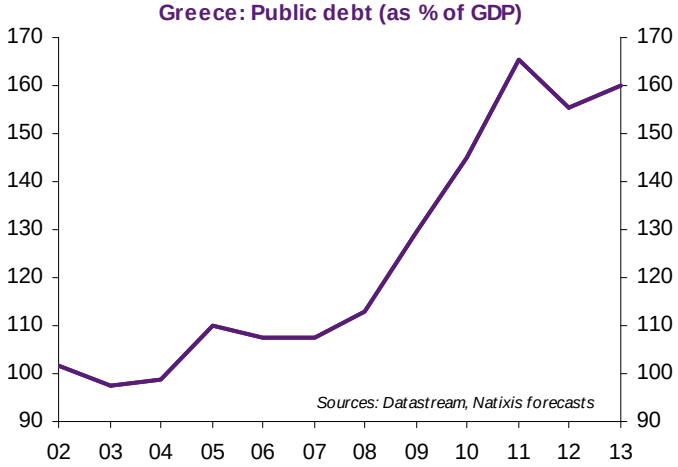


Chart 6C
Financial sector debt (as % of nominal GDP)

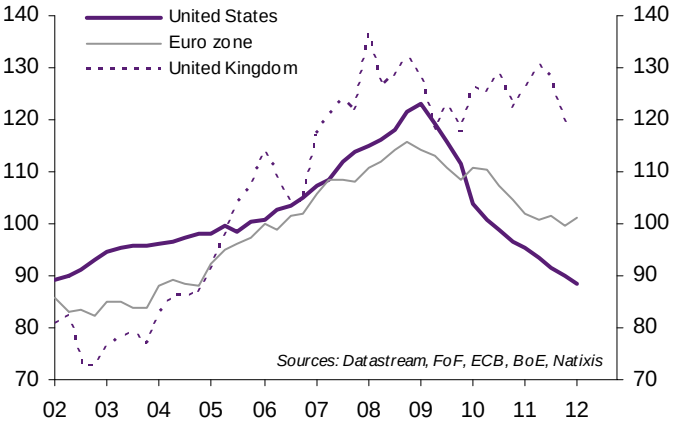
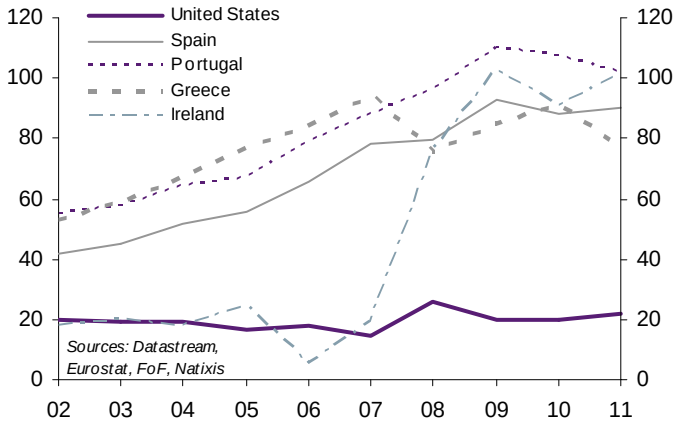


Chart 6D
Net external debt (as % of nominal GDP)



To prevent the excessive indebtedness that results from the absence of risk premia before crises, the following measures are being implemented currently:

- **banking regulations** (liquidity ratios, capital ratios, limits to debt leverage), aimed at curbing loans as well as the debt of the banks themselves;
- **public finance rules** (golden rule for instance) aimed at limiting fiscal deficits;
- **rules for macro-prudential supervision:** limits on lending to the private sector, external deficits, etc.

The problem with these various regulations is:

- **the risk of adjustment errors:** the new prudential rules for banks are being implemented too fast, which explains the credit crunch in the euro zone **(Chart 7);**
- **the risk of having simplistic rules:** the disappearance of structural fiscal deficit **(Chart 8A)** means that even public investments cannot be financed by borrowing **(Chart 8B);** the pressure to eliminate external deficits **(Chart 8C)** is incompatible with the existence of countries that have small industrial sectors **(Chart 8D).**

Chart 7
Euro zone: Central bank survey on changes in credit supply conditions

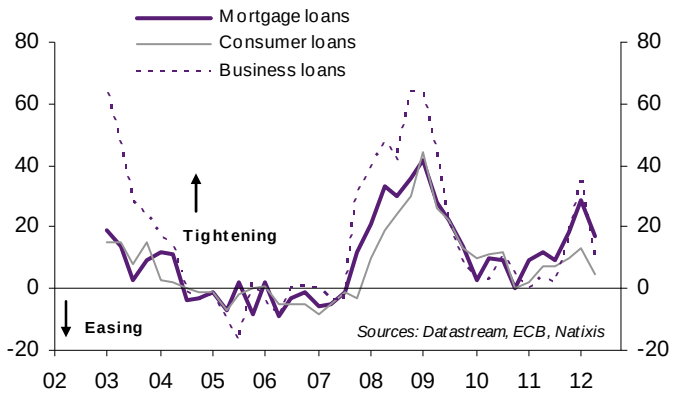


Chart 8A
Euro zone: Structural fiscal deficit (as % of GDP)

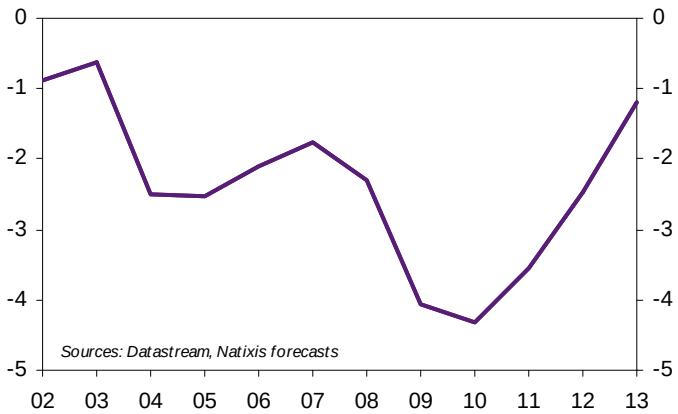


Chart 8B
Public investment rate (as % of nominal GDP)

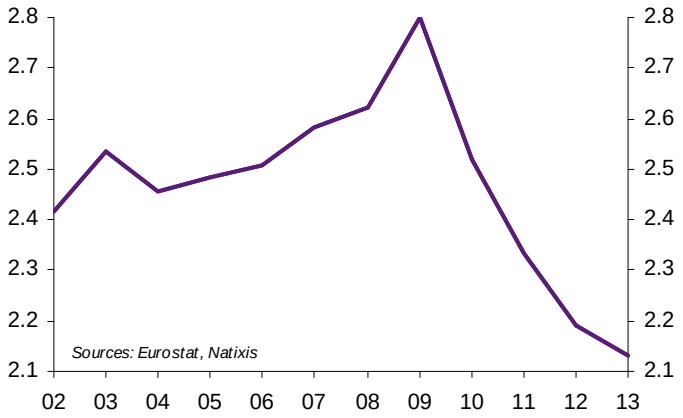


Chart 8C
Current-account balance (as % of nominal GDP)

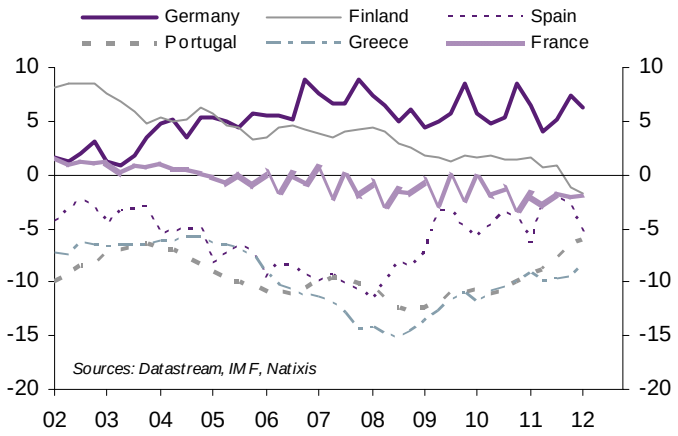


Chart 8D
Manufacturing value added
(in volume terms, as % of GDP)

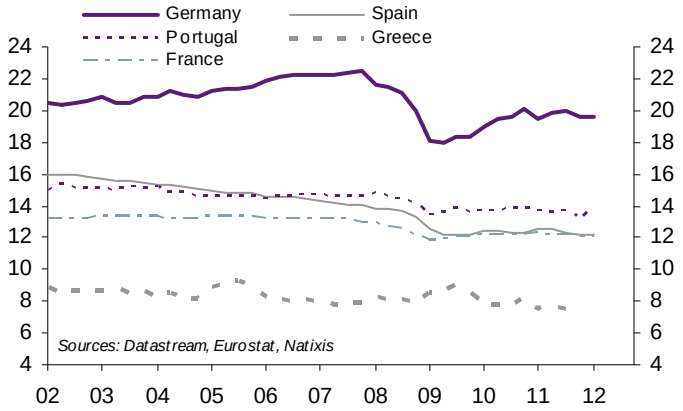
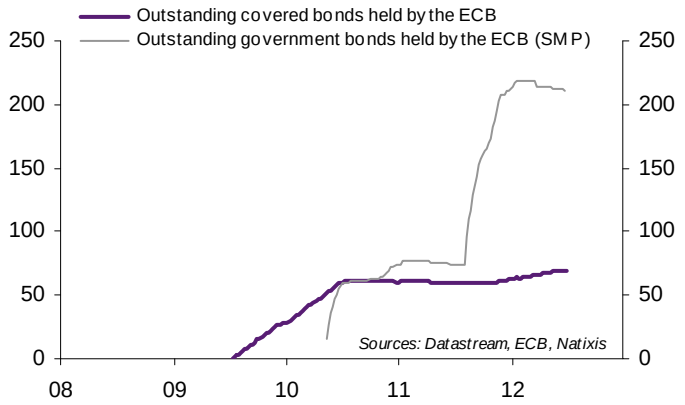


Chart 9
Outstanding covered bonds and government bonds debt held by the ECB (in EUR bn)



(2) Also, without market discipline, certain interest rates are abnormally high after crises (we saw above the case of **bank bonds**, **Charts 1C** and **D**, and certain euro-zone **sovereign bonds**, **Chart 1A**, and **agency bonds** in the United States). **This has forced central banks to intervene:** purchases of agency bonds with QE1 in the United States **(Table 1)**, the ECB's programmes to buy covered bonds and government bonds **(Chart 9).**

Table 1
Assets held by the Federal Reserve (USD bn)

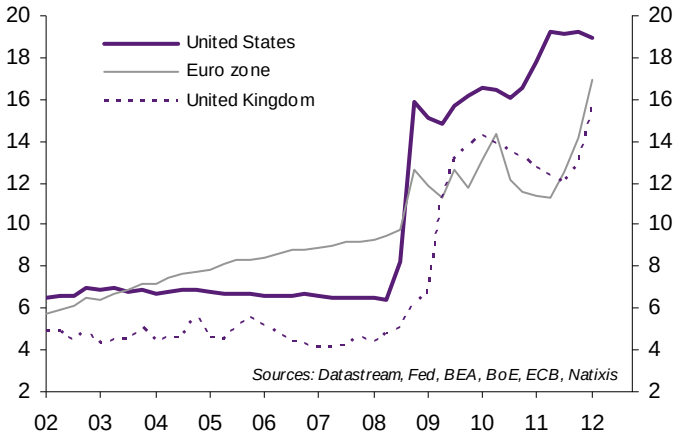
	US Treasury securities	Federal agency debt securities	Mortgage-backed securities	Repurchase agreements	Term Auction Credit	Other loans	Commercial paper	Liquidity swaps	Other Federal Reserve assets	Total factors supplying reserve funds
Q1 2008	629.0	0.0	0.0	84.8	80.0	33.5	0.0	0.0	43.4	921.3
Q2 2008	478.8	0.0	0.0	121.7	150.0	20.9	226.0	62.0	43.3	927.4
Q3 2008	476.6	3.7	0.0	111.7	150.0	187.8	282.2	135.2	41.0	1186.2
Q4 2008	476.1	19.9	0.0	80.0	420.8	196.9	325.8	543.6	43.7	2232.6
Q1 2009	474.7	48.8	237.0	0.0	468.6	134.3	240.8	327.7	49.0	2106.6
Q2 2009	647.8	92.1	467.1	0.0	282.8	123.7	140.8	121.6	73.0	2052.1
Q3 2009	762.7	126.9	689.2	0.0	196.0	111.1	42.8	59.1	85.1	2191.0
Q4 2009	776.6	158.6	904.6	0.0	75.9	87.1	14.0	12.1	99.5	2275.8
Q1 2010	776.7	167.5	1073.5	0.0	3.4	84.5	7.8	0.0	96.1	2357.1
Q2 2010	777.0	165.7	1128.4	0.0	0.0	69.4	1.0	1.2	94.8	2387.5
Q3 2010	801.2	154.2	1092.1	0.0	0.0	52.5	0.0	0.1	94.6	2346.1
Q4 2010	1010.3	147.5	1001.4	0.0	0.0	45.1	0.0	0.1	111.6	2467.3
Q1 2011	1295.4	138.9	944.0	0.0	0.0	19.8	0.0	0.0	120.2	2642.2
Q2 2011	1589.2	118.4	914.4	0.0	0.0	13.2	0.0	0.0	131.2	2886.8
Q3 2011	1663.6	108.3	875.7	0.0	0.0	11.5	0.0	0.5	132.4	2898.7
Q4 2011	1671.4	104.6	847.8	0.0	0.0	9.1	0.0	99.8	153.1	2980.6
Q1 2012	1667.9	96.8	845.1	0.0	0.0	7.1	0.0	65.1	167.9	2933.4
Q2 2012	1661.4	93.3	851.8	0.0	0.0	5.5	0.0	22.3	177.6	2891.7

Sources: Datastream, Fed, Natixis

These central bank interventions are dangerous:

- **associated monetary creation (Chart 10);**
- **moral hazards** linked to massive purchases of risky assets by central banks.

Chart 10
Monetary base (as % of nominal GDP)



Conclusion: It would be far better to have market discipline

The fact that market discipline does not function (risk premia are alternately abnormally low and abnormally high) **makes it necessary:**

- **to implement rules, which are inevitably imperfect, simplistic and too drastic, to curb indebtedness when risk premia are tool low;**
- **for central banks to intervene, leading to excess monetary creation and moral hazards, to reduce risk premia when they are excessive.**

How can reasonable market discipline be fostered?

- with investors that have longer investment horizons, and which are not compelled to follow trends;
- with "forward looking rating".

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