Fragmentation in the European Government Bond Market: The Risk of Mis-Pricing

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Roll-over Risk and the TPI

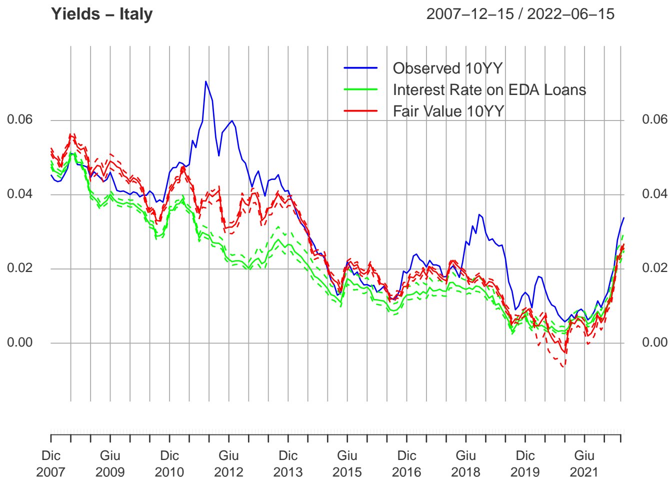
- The current macroeconomic conditions in Europe, characterized by high government debts, low growth, uncertain inflation and interest rates, make effective and efficient risk management for government debt more important than ever before.
- The main source of risk we are focussing on today is roll-over risk.
- Sovereign debt roll-over risk refers to the risk that a government may not be able to refinance its existing debt obligations as they come due or roll them over into new debt, causing a default. This risk materializes very rapidly with a collapse in the price of sovereign bonds.
- Roll-over risk can serve as a tool to deter excessive debt when bond prices are firmly linked to underlying fundamentals. However, its efficiency as a discipline device is hampered when bond prices diverge from these fundamentals.
- The ECB has recognized the possibility of deviation of bond prices from fundamentals by introducing the TPI i.e. the explicitly possibility of intervention in the secondary markets for bonds to stabilize their prices
- The main question, not tested insofar, related to the TPI is which is the level of fragmentation in the European bond markets that ignites ECB intervention.

Making the TPI work

- Our research team has proposed the issue of perpetual loans by an European Debt Agency as a framework to address roll-over risk.
- This proposal provides a reference methodology for identifying a suitable benchmark, conceived as an "idiomatic cost" applied to each MS's debt and computed as the fair price of a perpetual annuity granted by EDA to each MSs.
- Perpetual annuities are not traded but they are priced , considering their relative riskiness as reflected in a transition matrix (TM) from one class of risk to the other.
- Risk merit depends on assessments issued by the rating agencies and compliant with MS's macroeconomic fundamentals and probability of transition from one class to another are based on historical data for the last 30 years.
- This "idiomatic cost" reflects MS's fundamentals because, by its very intertemporal nature, it is able to filter market liquidity and refinancing risks.
- countries are allocated to eight risk grades we believe and the price of a perpetuity of each class of risk fluctuates in between those attribute the next upper class and to the next lower class of risk. This naturally provides an upper and lower bound for intervention.

Historical Measures of Inefficient Pricing

Ceci and Pericoli(2022) provide an estimate of the fair value of the Italian ten-year sovereign spread, defined as the value consistent with the country's macroeconomic fundamentals



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