Information Spillovers and Sovereign Debt: Theory Meets the Eurozone Crisis

Authors: Harold Cole Daniel Neuhann Guillermo Ordonez

Discussant: Federica Romei

FACTS

- Implicit return on German (G), Portuguese (P) and Italian (I) bonds were similar pre crisis, very different post-crisis
- Similar buyers pre-crisis, domestic buyers for I and P bonds after crisis
- Spread between primary and secondary market returns >0 for I and P bonds

This paper

This paper offers an explanation to these facts:

- Informed and non informed investors
- Normal times: no incentive to acquire information
- Difficult times: only informed investors participate to the auctions
- In difficult times: market segmentation

MY DISCUSSION

The paper is very polished

- A bit useless to ask for further things or make suggestions
- Possible explanations for resident VS non resident bond ownership… we are not going there!
- Use the framework/mechanism proposed by the authors to analyse past and current policies

Solutions to the Spread Increase

- ECB bought government bonds to keep yields under control in the secondary market
- Is this policy optimal in your framework?
- Maybe yes or maybe no
- However, in your framework can't the ECB do better?

Mixed-product Auction

- After the Northern Rock bank run, the Bank of England urgently wanted to lend money to banks to keep them liquid
- Problem: banks did not want to reveal their fundamentals by entering in one market
- Problem: banks were not informed enough, so they would rather preferred to be outside a market

A Problem with Auctions

- Assume you like oranges more than apples, however, there is a price for which you will buy apples rather than oranges
- Assume there are separate auctions for apples and oranges,
- Problem for the buyers: don't know which auction to enter, because they don't know which auction will offer them the better deal.
- Problem for the seller: they have to decide how many apples/oranges to sell in the apples/oranges-auction, before knowing anything about the market demand for either kind of fruit.
- Solution: sell all fruits together in a single auction that can take account of all the bidders' / sellers' preferences.

Solution

- Paul Klemperer was called by the Bank of England to solve the problem
- He designed a new Auction that would sell multiple related goods in an easy, informative, efficient and fast way.
- In the simplest version of Klemperer's design, each bank (bidder) could bid for two substitute "goods": three-month loans against strong collateral (e.g. UK sovereign debt) and/ or 3-month loans against weak ("extended") collateral

What can we learn from today's paper?

- Assume that the main problem after the debt crises derived by information acquisition
- Proposal: Maybe the ECB can run a modified version of the Mixed-Products Auction
- Instead of running many auctions in different markets why do not use the ECB to run a unique auction where she collect all the information of the sellers and buyers?