EUROPEAN CENTRAL BANK

EUROSYSTEM

29 September 2022

Ad-hoc call of the Bond Market Contact Group (BMCG) on 29 September 2022

Summary of the discussion

Members reported orderly bond market functioning in the euro area, despite the significant increase in volatility related to the most recent developments in the UK. Although bid/ask spreads widened, market makers continued to provide quotes and electronic platforms did not register a notable increase in the time to quote. The swap and corporate bond markets were described as the ones that were mostly hit by a decline in liquidity, which was however seen as a continuation of an already existing trend. While some members were surprised about the overall resilience of the euro area bond market, others mentioned that the structure of the UK bond market also contributed to the sharp moves, while euro area bond markets benefit from more diversity of participants and (maybe) lower underlying vulnerabilities in the pension fund industry.

On the events in the UK bond market, members were of the view **that the explanation for of the sharp repricing in bond markets was a perfect storm created by a combination of factors:** the announcement of more fiscal spending in the UK just before the planned new syndicated loan issue by the UK DMO, the scheduled start of active bond sales by the BoE, the hawkish tone of the Fed as well as lower liquidity around quarter-end. **Importantly, the move was exacerbated by technical factors, as derivative exposures of UK pension funds and the associated leverage caused margin calls,** which led to forced liquidation of bonds, resulting in an adverse self-fulfilling spiral.

There was a general feeling that going forward, **bond markets might show significantly less tolerance than in recent years to expansionary fiscal policies, in particular when these work at cross purposes with monetary policies.** Furthermore, the recent UK episode showed that markets might need some sort of (central bank) backstop that provides support to cope with unexpected market disruptions. **These targeted asset purchases should not be confused with quantitative easing and can also take place when central banks are raising rates.**