MAKING A MARKET: ON THE DIFFUSION, BENEFITS AND RISKS OF THE PRIMARY DEALER SYSTEM

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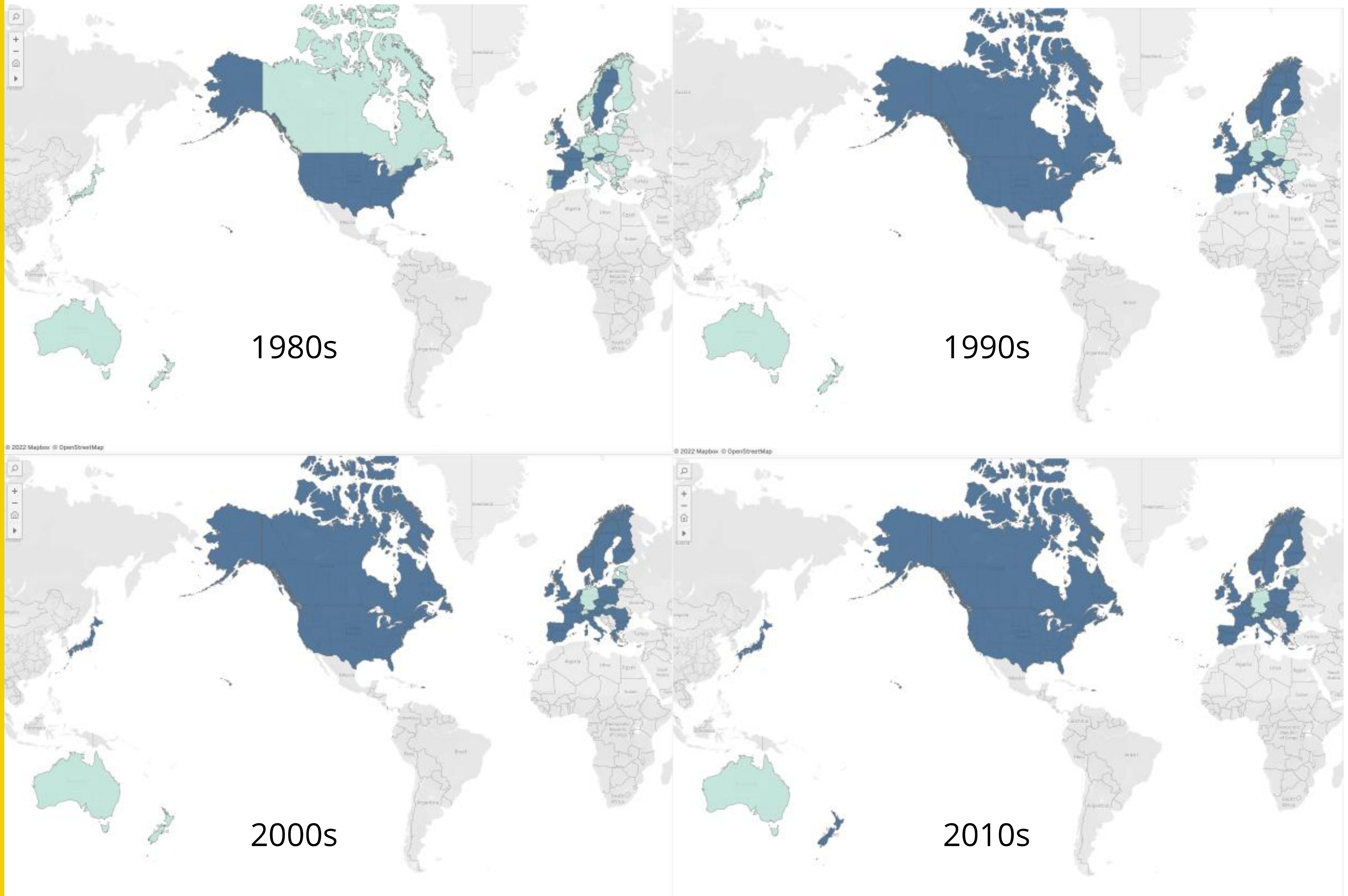
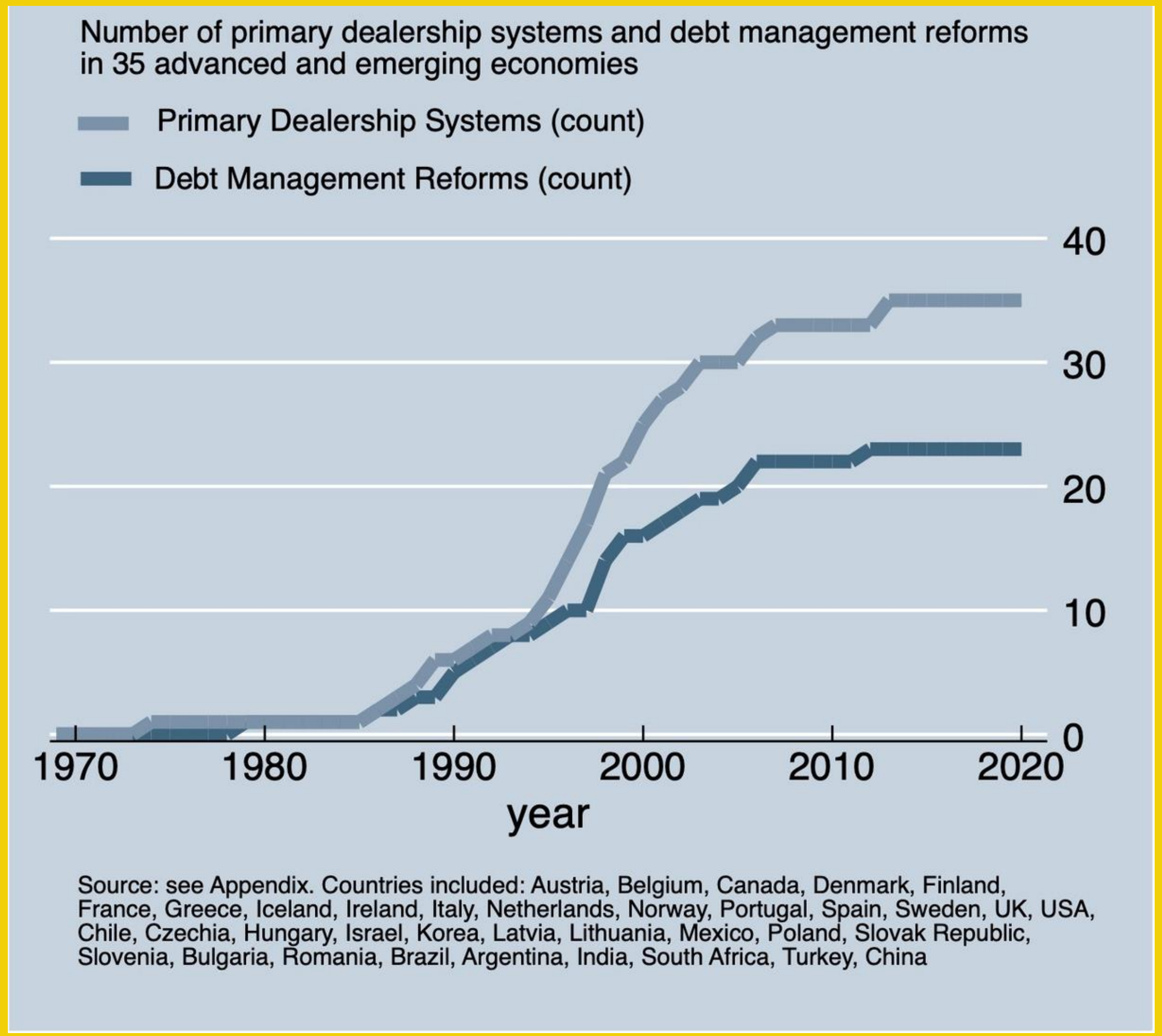
Figure 1. The spread of the primary dealer model



Transformation of Public Debt Management

KEY BUILDING BLOCK FOR MODERN DEBT MANAGEMENT



THE PRIMARY DEALER MODEL

- *specific design of primary dealer systems differs from country to country*
- *obligations & perks*
  - *submit (competitive) bids in auctions for government bonds & are required to do so in 'substantial', predefined ways*
  - *need to contribute to market liquidity by quoting executable two-way prices for government bonds on secondary markets according to set rules about the maximum spread or turnover requirements*
  - *enjoy the right to participate in syndications, have access to special (repo) financing facilities, and may benefit from any reputational gain stemming from their PD status as well as from informational advantages*

The fiscal side of the story

The fiscal side of the story

THE PDM PITCH

- *past: slow and predominantly domestic affair*
- *financial market liberalization of post-Bretton Woods period set off starter gun for the transformation of public debt management*
  - *introduction of PD system typically related to the problem of bringing down a government's financing costs*
- *a shift in thinking about debt*
- *Debt management = portfolio optimization*
  - *heightened role for liquidity and diversity of bond investors*
    - *Liquidity to be boosted by primary dealers acting as ready market makers willing to continuously quote prices at which they will trade on demand*
    - *Diversity to be increased by explicitly inviting foreign banks to participate in the PD system*

THE PD PITCH AND PD ADOPTION

Table 1. Survival Analysis of Primary Dealership Adoption

	(1) Model 1	(2) Model 2	(3) Model 3
Interest payments $_{t-1}$	1.276***	1.272***	1.231***
	(0.0681)	(0.0673)	(0.0704)
GDP per capita $_{t-1}$	1.413***	1.429***	1.499***
	(0.185)	(0.193)	(0.220)
Debt $_{t-1}$	0.984	0.982	0.987
	(0.0122)	(0.0125)	(0.0108)
Capital Account Openness		0.190	
		(0.198)	
Banking Concentration		0.624	
		(0.787)	
Right			0.419*
			(0.203)
Majority			1.033
			(0.0282)
Observations	653	646	579
AIC	-121.6	-119.4	-122.9
BIC	-99.18	-88.12	-92.36

Notes: Standard errors clustered by country in parentheses. *p<.10; **p<.05; ***p<0.01

Empirical analysis of PD creation (hazard model) in 32 advanced economies from 1970 to 2012

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cf. broader narrative around the appeal of the PD model as generating liquidity, diversifying the investor base, introducing competition and ultimately bringing down the costs of borrowing

THE PDM AND THE COSTS OF BORROWING

Explaining Annual Changes in Long-term Interest Rates

	(1) Model 1	(2) Model 2	(3) Model 3
Interest $_{t-1}$	-0.266***	-0.271***	-0.262***
	(0.0251)	(0.0255)	(0.0254)
Debt$_{t-1}$	-0.00348*	-0.00409**	-0.00473**
	(0.00208)	(0.00205)	(0.00222)
ΔDebt	0.00157	0.000783	0.000327
	(0.00623)	(0.00619)	(0.00633)
Openness$_{t-1}$	-0.885***	-0.919***	-1.003***
	(0.241)	(0.235)	(0.235)
Inflation $_{t-1}$	0.0971***	0.101***	0.0998***
	(0.0134)	(0.0134)	(0.0135)
Global Interest Rates$_{t-1}$	0.110***	0.117***	0.116***
	(0.0356)	(0.0359)	(0.0357)
PD $_{t-1}$	**-0.249***		
	(0.140)		
DMO $_{t-1}$		**-0.197**	
		(0.149)	
CBI $_{t-1}$			**0.0176**
			(0.161)
Constant	1.879***	1.846***	1.682***
	(0.366)	(0.377)	(0.353)
Observations	866	866	866

Notes: *p<0.10; **p<0.05; ***p<0.01, FGLS error correction model of annual change in long-term interest rates. Estimates of country fixed effects not shown in table for ease of presentation.

THE PDM AND THE COSTS OF BORROWING

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- *a) countries with a primary dealer model have experienced lower interest rates on long-term bonds*
- *b) PD reforms took place in a period of broad macro-financial reforms*
  - *controlling for debt management agency reform & central banking reform, the PD effect persists as a determinant of bringing down the costs of borrowing*

The monetary side of the story

USA: PIONEERING THE PDM

- *The pre-history traced back to the 1920s*
- *Contemporary story (Garbade 2021), starts in the 1960s when the Fed and Treasury conducted a set of joint studies pushing for the creation of a Primary Dealer Association*
    - *key motive for the establishment of the association = concern over a lack of effective regulatory oversight over the US-Treasuries market and the monetary policy implications thereof*
    - *PDs in US as monetary policy partners*
- *Primary Dealer Association a crucial and effective partner from the beginning, notably during the 1970s*
- *gained a positive reputation abroad for facilitating debt management*

THE UK:
THE BIG BANG AND THE PDM

- *1986, the Gilt-edged market-makers (GEMMs) explicitly modelled after the US*
- *Reforms were not driven by Treasury, but by the then executive director of the Bank of England, Eddie George*
- *not only meant to raise finance on better terms, but to improve the Bank's capacity of conduct monetary policy*
- *during the UK's post-war period proved difficult to fund the debt at long maturities on the scale desired*
    - *jobbers limited market- making power*
- *UK Treasury did welcome the introduction of GEMMs:*
    - *introduction of the PD system took place at a time when the national debt was rising*

ITALY:
EURO MEMBERSHIP AND THE PD SYSTEM

- precursor of a primary dealer system in Italy can be traced back to broad reforms of 1981 (incl. central bank independence) after which **s**ales of government bonds were done via a private banking consortium that had to sell at market prices
- reforms also put an end to the Banca d'Italia large scale bond purchases
  - interest payments increased
  - the new primary dealership model (1994) promised to bring funding costs down
    - Cf. tight Maastricht targets for entry into Monetary Union

ITALY: EURO MEMBERSHIP AND THE PD SYSTEM

- Influential technical solution of managing PD relations: MTS
- Set up in 1988 provided a platform where dealers could stream prices to each other, & Treasury officials could monitor dealers' commitment to market making
- Italian Treasury periodically started publishing ranking of specialists' market making: measure of performance
- MTS's data allowed for greater control about PD activity
  - History of PD abuse esp. in US, but also EU (e.g. Citi)
  - 'risk of collusion, price-rigging, or a tolerance for risk-taking within the 'ingroup'' (Yadev 2016)
- "liquidity Pact" of MTS
  - Appeal as competition intensified in the run up to EMU
- Today, league tables that rank the best performing PDs widespread practice

GERMANY:
MARKTPFLEGE AS PD SUBSTITUTE

- *'the cheaper option for the German taxpayer no to' (Gerhard Schleif then managing director of the Finanzagentur 2006)*
- *operates a quasi-primary dealer system, revolving around a group of dealer banks that face little to no hard commitments in exchange for access to auctions*
- *Why?*
  - *In 1987, the year that France introduced its PD system, debt servicing costs as % of GDP stood at 2.5 in France compared to 2.8 in Germany*
  - *1999, both countries faced an identical interest payment ratio at 3.3 % of GDP*

GERMANY: MARKTPFLEGE AS PD SUBSTITUTE

Thinking about 'how to do debt management' (esp. liquidity & diversity)

- *Germany has been relatively conservative in adopting debt management innovation compared to its immediate peers*
- *Wake of EMU: Bundesbank in its role as ‘fiscal advisor’ spoke out against the PD model*

Marktpflege

  - *keeps a share of the emission (up to 20%) in its own books for the purpose of market making*

- *Marktpflege as* ***liquidity machine***
  - *enables the debt management agency to act as market maker if need be, without committing primary dealer banks*

FROM THE DIFFUSION OF A MODEL TO THE PD SYSTEM IN PRACTICE

Continuing on a theme: ‘the neat-and-tidy world of debt management is a thing of the past’ (Bloomestein and Turner 2011)

FINANCIAL DOMINANCE?

- *fiscal dominance vs. monetary dominance vs. financial dominance*
- *Background:*
  - *bond yields across advanced economies declining*
  - *debt issuance favouring auctions*
    - *primary dealer business has been said to be unprofitable*
    - *Central Bankers & debt managers as de-riskers of PD activity*
      - *QE*
      - *Repo lending/support facilities*
    - *support for market-making ability of their primary dealers*
    - *support is not just important for debt management but also for monetary policy given primary dealers' key role in repo finance*

Table 2. Primary Dealer and repo market support, selected countries		
	Primary dealer and repo market support	Authority
Belgium	Secondary government debt market smoothing through selective provision of government securities	Belgian Debt Agency
Denmark	Securities lending facility provides government securities to Primary Dealers to support the functioning of the repo market	Danish Central Bank
France	Securities repo facility provides government securities to Primary Dealers to enhance the liquidity of government debt	French Debt Agency
Germany	Liquidity support and planning via 'Marktpflege'	German Debt Agency
Italy	Repo facility open to potentially all secondary market participants, designed to enhance goals of cash management and address situations of scarcity in specific securities	Italian Treasury
Netherlands	Repo facility allows Primary Dealers to obtain part of an unsold government debt auction via a repo transaction to maximise efficiency in debt auctions	Dutch State Treasury Agency
Portugal	Repo facility of last resort supports market-making obligations of primary dealers in secondary markets	Portuguese Debt Agency
Sweden	A standing repo facility governed by demand and offered irrespective of the borrowing requirement	Swedish National Debt Office
UK	Standing and special repo facilities to support primary dealers in their ability to make two-way prices in secondary markets and counteract severe market dislocations	Debt Management Office
US	Primary Dealer Credit Facility as well as Repo facilities (introduced at various points since 2008)	Federal Reserve

Sources: various central bank and debt management office websites

Table 3. Number of primary dealer banks in Europe

Country	2021	2019	2017	2015	2012
Austria	21	21	21	22	24
Belgium	13	11	19	22	19
Denmark	9	11	11	13	12
Spain	20	22	22	22	22
Finland	15	14	14	14	14
France	15	15	16	19	20
Greece	18	20	21	21	22
Ireland	17	15	16	18	16
Italy	16	16	18	20	20
Netherlands	13	13	16	21	16
Portugal	17	20	20	20	18
Sweden	7	7	7	6	8
Slovenia	15	14	14	15	14
Slovakia	12	11	11	10	22
UK	18	24	19	21	19

Source: AFME European Primary Dealers Handbook, various editions

FINANCIAL DOMINANCE?

- *Primary dealers' access to repo finance = market making, if not hugely profitable, will at least not turn (too) risky*
  - *PD models' intrinsic links with repo finance further suggest systemic vulnerabilities*
- *Role of repos in primary dealer activity key interface where central banking and public debt management meet*

SUMMARY

- *Primary dealer system swept the board*
  - *Key component of 'modern' sovereign debt management*
- *History of Primary dealers, both a monetary and a fiscal policy story*
- *Primary dealers are partners for*
  - *Central bankers (monetary transmission)*
  - *Debt managers*
- *Both central bankers and debt managers are de-risking PD activity*