Not risk free: The relative pricing of euro area inflation-indexed and nominal bonds

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Context of the paper

- Inflation Linked Bonds offer significant benefits compared to Nominal Bonds (e.g., Bodie, 2009)
  - Provide market based information on breakeven inflation rate
  - Provide a safe vehicle for retirement savings
  - Prevent investors from money illusion
  - Protection against deflation (deflation floor)
  - Relief issuer of paying an inflation risk premium
  - Reduce temptation of gvt to create inflation and lower real value of debt

Key findings

- Approach in the paper
  - Replicate nominal bond yields using ILB and inflation swap
- The relative pricing of ILBs versus nominal bonds + inflation swaps reveals that
  - ILBs are less liquid compared to nominal bonds
  - The market perceives ILBs to have higher credit risk (selective default)
- Investors consider governments less reliable in keeping their promises to pay inflation

Discussion

- Implicit question in the paper
  - Do investors find governments trustworthy in keeping their promise to pay (high) inflation
- How likely is that Germany, France or Italy will selectively default on their ILBs
  - Government revenues are positively correlated to inflation (not necessarily perfect to HICP)
  - Defaulting on ILBs implies paying inflation risk premium on nominal bonds
  - Little to no evidence on selective defaults
- Other explanations?

Other explanations for differences in break even rates

- ILBs vs nominal bonds
  - Indexation lag: it requires three months to gather data and calculate realized inflation (three months of uncertainty that needs to be priced)
  - Seasonal effects: ILBs that expire three months after retail sales are less attractive
  - Convexity effects: duration and convexity of ILBs substantially higher compared to nominal bonds

Other explanations for differences in break even rates (*cont.*)

- ILBs vs swaps
  - Less limitations: universe of ILBs is quite small compared to swaps
  - More diversification: inflation swaps are available for many maturities
  - Lower transaction costs: bid-ask is smaller for swaps as liquidity is higher

Other explanations for differences in break even rates (*cont.*)

- Liquidity measures and collateral management
  - Each country has an unique liquidity factor. How does this affect the cross sectional differences
  - CSA: differences in eligible collateral may impact swap value

Overall assessment

- Contemporary paper exploring important detailed pricing differences in bonds of core euro countries
- Strong points
  - Well structured and well written
  - Innovative identification strategy
  - Consistent approach

Overall assessment (*cont.*)

- Points that require attention
  - Add a numerical example of the replication strategy
  - Provide convincing evidence of selective default
  - Discuss alternative explanations
  - Base market factor on value weighted excess returns