Fixed Income

The Complexity of Liquidity: The Extraordinary Case of Sovereign Bonds

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Working paper

It is documented that government bonds with almost identical cash flows can trade at different prices. The explanation is that due to higher liquidity the most recently issued bond tends to trade at a premium to previously issued bonds. This paper analyzes the cross-section of bond spreads across developed countries over a 17-year time period. Indeed, liquidity has commonality across countries in the expected direction. However, the paper documents a novel finding that questions the standard view of liquidity. Under certain conditions, especially related to credit deterioration and flight to quality, new issue bond spreads tighten and can be negative. In other words, the liquid bonds become cheaper, not more expensive, relative to their less liquid counterparts. We offer an explanation based on price pressure and provide empirical support using data on net flows of investors in sovereign bonds. Of some interest, we are able to reconcile the differential behavior of bond spreads of the U.S. and Germany versus Belgium, Spain and Italy during the Eurozone crisis period.

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