DEBT MARKET TERMS

Bond

A debt instrument issued by a government or company. Investors buy bonds (thereby lending the government or company money) in return for an annual interest rate, and receive the full amount they lent at the end of the bond's term, also known as the maturity. A bond's maturity can be as short as a year to as long as 100 years. Different countries refer to their government bonds by different names: Gilts (UK), Treasuries (US) and Bunds (Germany).

Bond yield

We often refer to this as the interest rate paid on the bond. In fact, it is a little more complicated. After they are sold, bonds are traded in a secondary market. If you buy a bond at its original price, the yield will be equal to the interest rate (or coupon) the company or government must pay on that bond until maturity. For example, if you buy $1,000 of a bond with a 10% coupon at its original price, your yield will be 10%. If you only pay $800 for that bond, the yield will be higher because you are getting the same guaranteed return on an asset that is worth less.

The bond yield shows how likely a company or government is to default; the higher the yield, the higher the perceived risk of default. That is because when Spain looks more likely to default, demand for Spanish debt falls; the price of Spanish bonds drops and the yield on Spanish debt rises. Yield is also a good proxy for how much interest a company or country would have to pay on their debt if they were selling new bonds.

Bond auction

Government bonds tend to be sold via an auction because the secondary market for government bonds is relatively active, so it is easy to find out the price of a bond equivalent to the new bond being issued.

Investors will put in bids for the new bond with the debt management office (DMO) of the country selling bonds. If an investor wants their full order they will usually put in at least the market price or higher. The DMO will fill up the orders at the highest prices first, gradually working down the list. Sometimes it may choose not to issue the full amount of bonds on offer, if it considers the prices offered too low.

Bid-to-cover ratio

The value of bids divided by the value of bids accepted in a bond auction. This gives a good idea of the demand for a particular bond. The higher the ratio, the higher the demand.

Long tail

In the debt markets, a long tail means a large difference between the average price and the lowest price paid for a bond in the same auction. This is not necessarily a sign of a weak auction, as the vast majority of bonds may have gone for a good price but a few small orders could have been filled at a much lower price.

Bond syndication

Corporate bonds tend to be sold via a syndicate of investment banks who market and place the bonds. They will go to investors and ask them to put in an order at a suggested price. The current trend is for investment banks to start with an extremely cheap price to reel investors in, but ratchet the price up when the bond is issued. The banks will also increase the size of the bond if they possibly can.

Spread

The difference between two figures. Often used when comparing bond prices. When considering the differing fortunes of Greece and Spain, traders might look at the spread between German and Italian bond yields. It tends to be measured in basis points, which are fractions of percentage points. 100bp = 1%.

Credit default swap (CDS)

Often referred to as an insurance policy against a company or country defaulting. In fact, CDSs are more frequently used to bet that a company or country will default, rather than to protect against any losses if it does. Investors pay a fee to hold a CDS and will receive a payout if the company or country defaults. Crucially, the investor does not need to hold the debt of the company or country in question.

Credit event

A credit event is the moment the ISDA (International Swaps and Derivatives Association) committee decides there has been a default, triggering the payout due to CDS investors.

Credit rating

A rating based on the likelihood a company or country will default. There are three main credit rating agencies – Standard & Poor's, Moody's and Fitch. Ratings go from AAA, which is considered very safe, to D, when a company or country is in default. Anything below BBB is considered junk, or speculative grade debt. The agencies often signal that they are likely to downgrade a particular country by putting its rating on "Outlook Negative" or "Creditwatch Negative".

The International Swaps and Derivatives Association (ISDA)

A trade association for derivatives that are traded directly between two parties – called over-the-counter trading – rather than via an exchange. It aims to make these opaque markets safe and efficient by helping resolve disputes.

POSSIBLE REMEDIES

Long-term refinancing operations (LTROs)

These involve the ECB lending money to banks in the eurozone at very low rates. This flood of cheap money is intended so that banks can lend more money to businesses and consumers, which would in turn help boost economic growth. The ECB has carried out two LTROs since December last year, lending a total of more than €1 trillion.

Quantitative easing (QE)

A policy used by the Bank of England in the hope of stimulating the UK economy. The Bank of England, with the permission of the Treasury, creates money by crediting its own account. It uses that money to buy government bonds from banks, pushing the price of the bonds up and the yields down (see bond yield), thus driving down the government's borrowing costs. The hope is that banks then have more money to lend to businesses and consumers. Theoretically, when the economy has recovered, the Bank of England sells the bonds it has bought and destroys the cash it receives, so there has been no extra cash created. So far, the Bank of England has injected £325bn into the economy in this way.

European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM)

Also known as the firewall. The ESM is a permanent rescue fund to replace the temporary EFSF. When the debt crisis erupted, the 27 member states of the EU agreed to create a fund, financed by the members of the eurozone, to provide financial help to eurozone states in economic difficulty. The EFSF is backed by commitments for a total of €780bn and has a lending capacity of €440bn. As Europe's largest economy, Germany provides the largest commitment to the fund and therefore wields the most influence in negotiations over bailouts and the size of the fund.

The EFSF is due to expire in 2013 due to the lack of a legal basis for the fund, although the programmes to deliver €300bn in loans to Ireland, Portugal and Greece will run their course until 2015. The ESM will be launched as soon as member states representing 90% of the capital commitments have ratified it, which is expected in July 2012, and it is able to run in tandem with the EFSF. Its lending capacity has been capped at €500bn.

Securities market programme (SMP)

The programme that allows the ECB to buys bonds from troubled eurozone countries, to help keep their borrowing costs down. The central bank has left the programme unused of late but executive board member Benoit Coeure reminded markets it was still an option in April this year. It is a tool favoured by the troubled nations as SMP bond purchases do not come with conditions.

Eurobonds

Proposed debt instruments that would be issued by an individual country within the eurozone, but underwritten by all members of the eurozone. This would bring down borrowing costs for the most troubled countries in the eurozone. But critics say they open up a so-called "moral hazard": if profligate behaviour goes unpunished, what's to stop any country going on the national equivalent of a bender and expecting Germany to pick up the tab? French president François Hollande, Italy's prime minister Mario Monti and Spain's PM Mariano Rajoy all want to bring them in, but the Germans, Finns and Austrians are against them.

Financial transaction tax

Otherwise known as the Tobin tax, or (emotively) the Robin Hood tax. The FTT would apply to all 27 EU countries and the European Commission says it could raise €55bn a year, ensuring the sector made "a fair contribution" in an austere economic climate. But critics say it is distorting and the volume of transactions would fall so it would not raise that level of funds. Support from the tax comes from an unlikely alliance of actor Bill Nighy, the Archbishop of Canterbury, and president of the European Commission José Manuel Barroso, among others; David Cameron is against it.

Fiscal compact

A treaty signed by all members of the European Union, except the UK and the Czech Republic. The fiscal compact will force member states to hit tough budget targets, which would mean more short-term pain for a country that is already deep into its austerity programme. But the fiscal compact will also guarantee access to the European Stability Mechanism. Despite signing the compact in January, Ireland subsequently decided to hold a referendum on it on 30 May 2012.

The Greek memorandum

The treaty that obliges Greece to make swingeing cuts to public spending in return for its second eurozone bailout worth €130bn in addition to a €100bn writedown of debt by the bankrupt country's private creditors. The mainstream parties in Greece have committed to the memorandum, but Alexis Tsipras, who heads Syriza – a coalition of radical left groups that took 17% of the vote in the May 2012 elections – has called it "a path that will lead to hell". The second round of elections on June 17 – after the politicians failed to form a government the first time round – has therefore been portrayed as a choice between sticking to the memorandum to stay in the euro, or abandoning austerity and leaving the single currency.

INSTITUTIONS

International Monetary Fund (IMF)

The IMF lends to countries in difficulties on condition that they follow its guidelines for fixing their economy. It has 188 member countries who provide $364bn of resources to the fund. In April 2012, member countries announced additional pledges to increase the IMF's lending resources by over $430bn to go towards bailouts for countries hit by the global financial crisis.

European Central Bank (ECB)

The institution in charge of monetary policy for the 17 eurozone countries, headquartered in Frankfurt, Germany. The current president of the ECB is Mario Draghi, former governor of the Bank of Italy. As Europe's biggest economy, Germany's central bank (the Bundesbank) holds the largest portion of the bank's €10bn capital, almost 19%. The governing council of the ECB comprises an executive board and the governors of the national central banks of the eurozone.

Eurogroup

An informal gathering of the finance ministers of the eurozone, currently headed by the prime minister of Luxembourg Jean-Claude Juncker. The Eurogroup usually meets the evening before the full meeting of the ECOFIN Council, which meets once a month. The ECOFIN Council is a group of the economics and finance ministers of the 27 European Union member states, as well as budget ministers when budgetary issues are discussed.

Troika

The trio of the IMF, the EU and the ECB managing the bailouts of European countries.

European Union (EU)

The economic and political partnership between 27 European countries that together cover much of the continent.

European Commission (EC)

The European Union's executive body. The EC proposes legislation to go through the European Parliament and Council. It manages and implements EU policies and the budget, and enforces European law (jointly with the European Court of Justice). The 27 commissioners (one for every member state of the EU) meet once a week in Brussels.

European Parliament

Members of the European Parliament (MEPs) are voted for directly by EU voters every five years. Together with the European Council, the European Parliament debates and passes European laws and the EU budget.

European Council

The heads of state or government of the 27 EU member states, along with the president of the European Commission, José Manuel Barroso, and the president of the European Council, currently Herman Van Rompuy.