Faulty Plumbing: Market Liquidity and Recent Impairment

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13th IMF Public Debt Management Forum and 3rd U.S. Treasury Roundtable on Treasury Markets and Debt Management
June 20, 2013
What Drives Liquidity?

Liquidity = Capital * Leverage * Trust

Today v. 2008:
- Capital stock is lower, though rebuilding.
- Leverage is vastly reduced.
- Several factors have recently damaged trust:
  - Specter of QE tapering
  - Regulation-mandated attenuation of bank balance sheets
  - Worsening macro fundamentals

These asset classes merit particular consideration:
- Local Currency Bonds
- Interest Rate Swaps
- Credit Default Swaps
- EM FX Options

Trends Transforming the Landscape
- Dramatically enlarged participation of non-dedicated players
- Disappearance of shadow banking/synthetic credit
Liquidity and Market Discontinuities
10-Year ZAR Swaps
Pre-Crisis: Large, Diverse Banking Sector Provides Bidirectional Liquidity

“Foreign” Asset Managers

Sell Side
- Market making
- Liquidity provision
- Risk distribution
- Risk warehousing

Local Institutional Buyers

Shadow Banks/SIVs

Issuer:
- Sovereigns/Corporates
Crisis Responses Catalyze Unintended Consequences

Bleak Macro-Realities
- Collapsing aggregate demand

QE
- Forced liquidity expansion

Widespread Search for Yield
- Institutions and retail join the fray

One-Sided Market
- Everyone's a buyer

Liquidity Impairment
- Capital requirements (Basel III, CRD4)
- No prop trading (Volcker Rule)
- Operating constraints (Dodd–Frank, CCP)
- EU CDS naked short-sale ban
- Demise of shadow banking/SIVs
- Hedge funds under attack

Sell Side Becomes One-Way Valve
- Less willing to warehouse risk

Now
- End of QE looms.
- Concentrated large positions face inadequate exit routes.

Procyclical Post-Crisis Policy Decisions

Sell Side

Now
Now (QE World): Smaller, Consolidated Banking Sector Unable to Meet Liquidity Needs of Enlarged Market Players

“Recency” Effect
One-sided flows make entry easy but exit difficult

“Foreign” Asset Managers
• Larger, more concentrated, less liquid positions
• Long-only buy side

Where are the shadow banks?

Local Institutional Buyers
• Larger domestic banking systems
• Expanded institutions

Decreased Volumes
Illiquid markets become even more illiquid

Sell Side

Issuers
• Sovereigns/Corporates
Is the Solution a Paradigm Shift?

Fragile circumstances demand difficult choices.

**EITHER**
1. New interconnections between players.
2. More active role for central banks and issuers (liability management, buybacks).
3. Regulatory forbearance and shift away from conception of “evil” hedge funds.
4. Involvement of retail.

**OR**
Leave it to the market – price clears.
Possible Solution: Interconnected Players of Comparable Size Enhance Liquidity

Issuers (Sovereigns/Corporates)
- Liability Management
- Volatility Smoothing

Sell Side

Clearinghouse

“Foreign” Capital
- Retail
- Institutional

Local Institutional Buyers

Retail

Institutional Clearinghouse

Sell Side
Points to Ponder

How will the IMF respond to this new strain of virus?
• Specific programs for countries plagued by inelastic current account balances?
• A special focus on turbulence in local-currency fixed income unrelated to macro fundamentals?
• A standardized regime for defaulting sovereigns?

• Shadow banking, for all its evils, provided speculative liquidity and shock absorption. What will replace it?

• Central banks have historically monitored FX volatility, but now must deal with interest rate volatility as well.

• Procyclical pension fund risk management further confounds the liquidity mix.
• Is expanded retail activity in all asset classes a necessary condition for liquidity improvement?