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MINISTERIO DE ECONOMÍA Y COMPETITIVIDAD

Session 4: Cross-Country Comparison of Drivers of Liquidity

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Liquidity in the Spanish Sovereign Debt Market

Difficult to pin down a single metric for liquidity: a combination of factors

- Ad hoc definition of secondary-market liquidity in Spain's Government bond market:

  "The willingness of market makers to commit to quoting and trading an adequate volume of bonds transparently, publicly and competitively"

- ➡ This definition helps us observe aspects of liquidity empirically, understand the determinants of liquidity and identify the benefits of a liquid market.

Trading and turnover of Government bonds

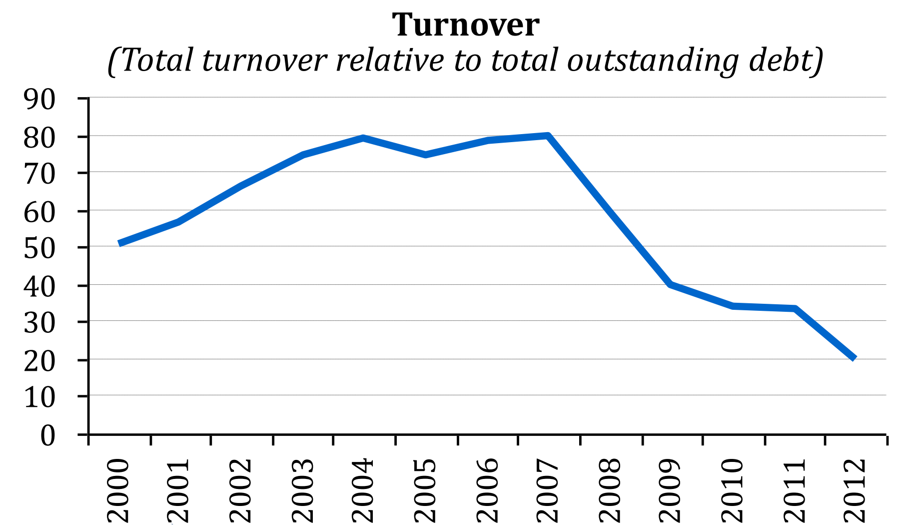
- We measure total turnover of bonds in electronic platforms, voice brokering and with final clients.

Quoting in Electronic platforms

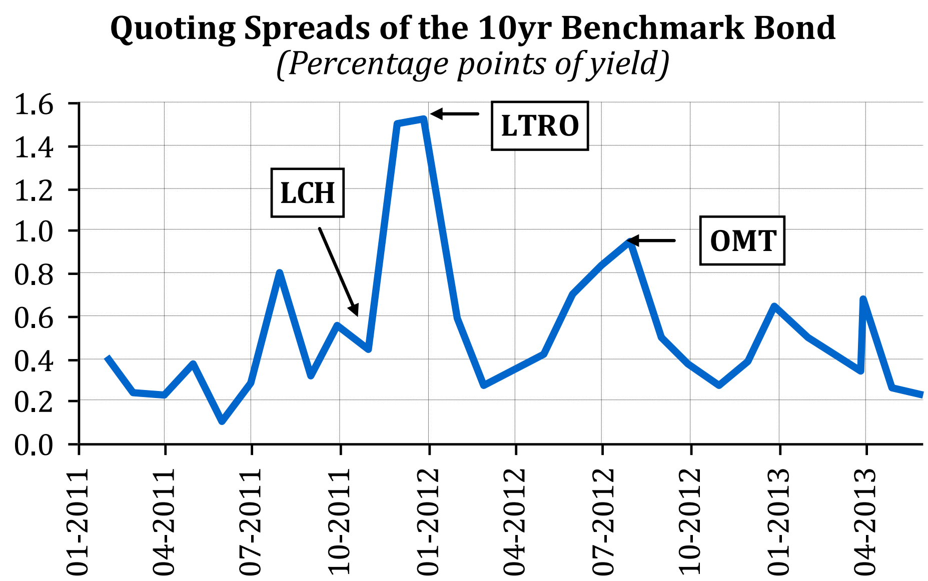
- Bid-offer spreads are a crucial variable, but not the only one.
- We also look at number of bonds quoted on the curve, volume quoted per bond and the number of hours quoted under those conditions – all of these show willingness to provide liquidity
- Liquidity is a public good that should be rewarded in different ways. The Spanish Treasury evaluates liquidity provision through various indices, and rewards it with *non-comp rounds* and with occasional syndicated issuance.

Liquidity in the Spanish Sovereign Debt Market

- **Trading turnover is the simplest metric to observe long-term trends**
  - ❑ Liquidity has deteriorated since 2007
  - ❑ Annual turnover fell from 80 times to 20 times outstanding debt



- **Bid-Offer quoted yields reflect medium-term liquidity tensions**
  - ❑ Sharp deterioration in November 2011, with LCH increasing Italian margins
  - ❑ Substantial improvement with LTRO auctions and OMT announcement



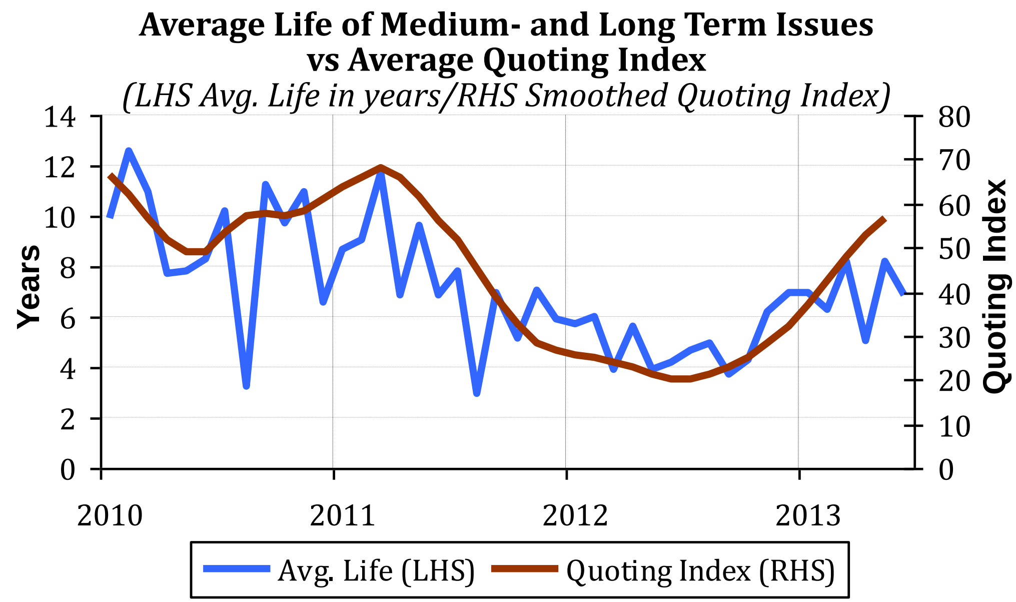
Liquidity in the Spanish Sovereign Debt Market

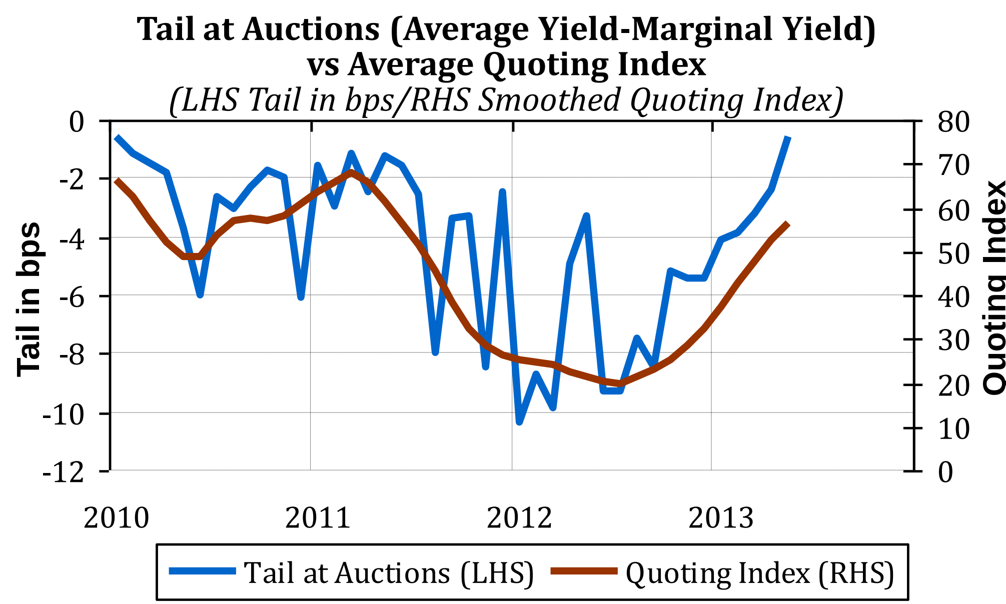
A composite index of quoting effort

- For each bond, a Primary Dealer obtains a daily score which is a function of:
  - Quoted spread (-)
  - Volume quoted (+)
  - Time quoted (+)
- This aggregate index is a good measure of a trading desk's **willingness** to provide liquidity in volatile markets.

Liquidity enables market access

- "Willingness to quote" is correlated…
  - …Positively with the average life of the Treasury's issuance
  - …Negatively with "tails" in primary auctions (average – marginal yield)
- **Causality**: usually, better quoting and trading encourage and improve issuance, but a feedback loops are possible.





Liquidity in the Spanish Sovereign Debt Market: Conclusions

- **Positive and negative feedback loops between liquidity and issuance**
  - ❑ Better liquidity generates investor demand in longer tenors, encourages Treasuries to issue
  - ❑ Issuance in longer tenors generates the incentive for dealers to quote and trade the product

- **Liquidity is a Public Good**: a collective incentive to ensure it, a private incentive to free ride

- **Liquidity does not emerge naturally: it is encouraged or discouraged!**
  - ❑ The issuer should incentivise competitive secondary-market liquidity
    - ❑ Non-comp rounds for satisfactory quoting, none for poor quoting
    - ❑ Secondary-market evaluation informs selection of benchmark syndicates
    - ❑ Regular issuance in key tenors
  - ❑ Availability of **repo financing**: Central Counterparties (CCPs) contribute to the public good of liquidity and should therefore be actively supervised and regulated.
  - ❑ Recent **regulation** affects the ability to warehouse bonds in long or short positions. Care should be taken to balance two public goods: financial stability vs availability of liquidity

Thank you for your attention

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