Do we have a liquidity problem post-crisis?

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Generic illiquidity argument

- The Dodd-Frank Act’s reform measures—namely higher capital requirements and the Volcker rule—have forced drastic dealer deleveraging.

- With dealer balance sheets contracting significantly, they are no longer able to make markets—especially in times of market stress.

- This has lead to severely less liquid fixed income markets.

- So what story does the data tell?
Treasury Market

- The most common trading cost metric, bid-ask spreads, has been tight and stable for the past 6 years.
- “Noisiness” of Treasury yields, another liquidity proxy, is at pre-crisis lows.
- Some measurements, including average trade size and market depth have deteriorated—but the changing structure of the Treasury market, namely the influx of High Frequency Trading, is a reasonable explanation for the post-crisis change in these specific metrics.
- Overall, Treasury market liquidity appears to be in pretty good shape.

Source: Federal Reserve Bank of New York calculations based on data from BrokerTec.
Corporate bond market

- The data shows that the corporate bond market is arguably more liquid than before the crisis.
- Issuance in the corporate bond market has been at all-time highs in the past few years, with investment grade issuance up 7.5% YTD.
- Bid-ask spreads are stable and even tighter than pre-crisis levels.
- Trade size decreased after the crisis and has not fully recovered, but the price impact of trades is at pre-crisis lows.
- In the high yield segment, the concern over the past few years has been froth, not illiquidity.
Dealer behavior

- Beyond the picture painted by the liquidity data, the illiquidity argument itself doesn’t line up with the logic of dealer behavior.
- During times of market stress, dealers do not “catch the falling knife.”
- Dealer leverage is procyclical, and much of the dealer deleveraging post-crisis happened before the passage of Dodd-Frank.
- During the “taper tantrum” in 2013, the FRBNY found that dealers with more Tier 1 capital tended to reduce their positions even more than dealers with lower capital ratios.
- This is the opposite of what we’d expect to see if higher capital was to blame for reduced market making during stress.

Source: Federal Reserve Bank of New York, via Senate testimony of Antonio Weiss
Future priorities

• Strengthening financial reform
  - If anything, patches of market turbulence in the past few years have shown the importance of financial reform.
  - U.S. financial institutions have more stable funding, hold more liquid assets, and have higher capital cushions than before the financial crisis, enabling them to survive periods of stress.
  - Too many important Dodd-Frank reform rules remain unfinished 6 years later. Strong rules on executive compensation, derivatives, conflicts of interest, and asset management must be finalized in the coming year.

• Increasing market transparency
  - The new Treasury market reporting rules are a good step to ensure regulators have access to vital data on this $13 trillion market that is crucial to the global economy.
  - Other areas where the official sector should have better access to data include tri-party/bilateral repo markets and Volcker rule compliance.
References