Discussion 2

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I want to thank the Bank of Canada for inviting me to speak at this conference and also for their choice of topic. Many forums over the years have examined the macro aspects of financial markets, but less work has been done on the micro aspects. This is an area where much more work needs to be done, and this conference plays a very useful part in that process.

I will offer some general comments before focusing on particular issues. First, my observations are from the perspective of a practitioner, not an economist. Second, there is so much rich material here that I will not be commenting on it all, and in any case, I am fortunate to be following John Chant, who covered a lot of ground already. Instead, I want to focus on a couple of topics and in particular I want to talk about liquidity and why it is something that central banks should care about. Third, I want to congratulate the conference organizers for bringing together an impressive mix of the theoretical and the practical. Theoreticians and market practitioners sometimes have a difficult time talking to one another, but the dialogue dovetailed very nicely here.

At a conference like this, there are two things you can count on hearing from most attendees with regard to markets and central banking operations. First, the more transparent the marketplace, the better. And second, central banks are insufficiently transparent about their operations. So it was somewhat of a surprise that we had a paper asking whether securities markets should be transparent. That the question was raised at all was in itself novel. We then had a presentation suggesting that so-called secret, foreign exchange intervention, which has been derided in the academic literature for most of the last decade, could be a legitimate operational tool.

Let me talk a little about liquidity. I will start by looking at what it is, why it is important, and what can or should be done about it. I think of liquidity as the ability to transact reasonably large-sized orders at or near the current market rate. Related concepts used to examine market liquidity include bid-offer spreads, depth of market, and continuity of price. The way that I have defined liquidity says nothing about turnover, about how many dealers there are, or even what type of market is in play—whether a traditional physical exchange, an electronic marketplace, or dealer-driven, to take three examples.

I will look at why liquidity is important from the perspective of three groups of interested parties on the official side: (i) policy-makers responsible for managing the economy; (ii) regulators responsible for overseeing financial institutions; and (iii) central bank officials responsible for implementing decisions taken by policy-makers. First, for policy-makers taking the view from a broad, macro perspective, liquid markets are an integral part of risk transfer and the risk-distribution mechanism. It enables those who are unwilling to hold risks to transfer them to those who are, and it is one of the keys to achieving an efficient allocation of resources.

Second, from the regulators' perspective, as Jerry Goldstein from the Superintendent's Office succinctly explained yesterday, liquidity is the ability of regulated institutions, and even of those who aren't regulated, to fund themselves efficiently. I would add that it also includes their ability to change their risk profiles quickly in the derivatives or securities markets. From the perspective of regulators, liquidity is very institution-focused.

Third, for central banks actually implementing policy, I think that last night Governor Dodge elegantly described the importance of liquidity to central banks. Financial markets are how we implement monetary policy. A deep, liquid market that allows a central bank to expand or contract its balance sheet without disturbing asset-price relationships is important. We sometimes call this neutrality—we do not want to affect asset-price relationships by our own actions and thereby favour one group of issuers over another.

If we consider the Federal Reserve and other central banks ten years ago, the issues of what assets central banks should be buying and where there were deep, liquid markets did not even arise. Our governments were running large budget deficits and debt levels were rising, so there were lots of securities to buy and the markets tended to be quite liquid. Now we have a different situation. We have had surpluses, not only in the United States, Canada, and Australia, but in other OECD countries as well. A number of countries are actually paying down debt. But liquidity can be adversely affected by merely running smaller deficits. If the amount of money that needs to be invested, in aggregate, is increasing, and if the stock of government debt is not increasing at the same rate, the proportional size of the risk-free asset is shrinking. That dynamic is even more acute in situations such as those in the United States and Canada, where the stock of debt is actually being paid down. At some point, the implications for liquidity and turnover in the markets have to be considered by the central bank.

If the ability to move seamlessly in and out of the government securities market is hindered, a central bank has to consider other possibilities. In most cases, the alternatives for central banks are not particularly attractive, especially if they have been accustomed to a very deep and liquid government securities market. To maintain a sovereign portfolio, one could buy foreign sovereign bonds. As I have said, however, many countries are paying down their debt and they would also have to face the foreign exchange risk. Alternatively, the central bank could buy other assets in the home country outside of the sovereign sector. But then, by definition, that means taking on greater credit risk, which would still result in less liquidity than in the past.

So what kinds of assets might one look at? They will vary from country to country and from situation to situation, but the possibilities include municipal debt, agency debt, mortgage-backed securities, and corporate debt. Each one has aspects that are not attractive in the sense of credit-risk characteristics, liquidity characteristics, tax aspects, etc. This means that the central bank must understand the liquidity characteristics of each market that much more as it makes its decisions about the future. Trade-offs between competing criteria—say creditworthiness and liquidity—are inevitable and choices will have to be made.

If you accept that at some point central banks may have to migrate to other markets, and that possibility has been considered seriously in many countries, then the importance of liquidity in markets for central banks is even greater. This leads to a question raised yesterday: if you accept that liquidity is important to the public sector, what can the public sector do to foster deep and liquid markets? In many ways, the best starting point is reflected in the Hippocratic Oath—do no harm. In other words, the public sector can start by removing obstacles that are currently holding back a fluid and flexible marketplace.

What kinds of obstacles am I talking about? Examples are legacy rules that inhibit turnover and liquidity, or more commonly, tax rules such as transaction taxes or withholding taxes that hinder trading or push it offshore. There may be legal barriers such as uncertainties about the status of contracts between counterparties. Public officials can help to alleviate this somewhat by fostering the development of master agreements that provide for legal certainty. Japan is a good example, where in the JGB (Japanese government bond) repo market there is a withholding tax that is being eliminated and a new master agreement that is being developed. However, Japanese tax authorities are proposing a tax on certain cross-border repos, which would tend to impede transactions.

What are some positive steps that the public sector can take to enhance liquidity? In addition to a strong legal foundation, another important feature for deep and liquid markets is a robust clearing and settlement system. We can think of a number of examples where there were issues or problems with clearing and settlement systems. To the extent that these issues keep participants away because they can't be sure about the clearing, settlement, and custody of their securities, enhancing those systems may help.

If you have done all that and you have an open market, a sound legal structure, good settlement systems, and no other impediments, what more can one do? There may not be very much more that can be done. But we should keep in mind that—at least in my view—liquidity is not binary. It is not yes or no. It is constantly evolving and adjusting to the situation, the environment, and the profit opportunities in that market.

To use the U.S. government securities market as an example, in the mid-1980s, U.S. federal deficits ballooned, increasing the supply of debt. There was volatility in interest rates, volumes were increasing, as was liquidity. One could move large-sized trades at narrow spreads, and the profit opportunities were seen as attractive and plentiful. The number of primary dealers grew to at least 45. In the last few years, we have had a different environment, with decreasing debt supply. The profit opportunities have also changed. We have had some entries and exits from the primary dealer ranks, but the reduction of the number of primary dealers comes from consolidation; the list is now down to about 24. One commentator suggested that the number of primary dealers has adjusted to reflect the current level of profit opportunity. Has liquidity declined? One can certainly say that the nature of the liquidity has changed. Large sizes can still be moved in that market. However, capacity has adjusted to a new quantity of risk that needed to be transferred, as well as to the improved technology, which has increased productivity among the dealers.

I think my message here is that it's very difficult, from the public sector perspective, to manage and foster an increase in liquidity once you have taken away all of the obstacles that may have hindered development of the market. The market has to—and does—find its own level of liquidity, even though the process does not always appear smooth when we are going through it.

In my remaining time, let me say a few words about the very interesting discussion this morning on stress in markets and contagion. A lot of work has been done in the public sector, at the IMF and the BIS, and in academia in identifying contagion and finding ways to prevent it. That is a very tall order and I don't quite know how one goes about doing so. In part, that is because there are various forms of contagion. Many of the ideas to counter contagion involve constricting how markets work, which, in turn, may affect financing to emerging markets. But it does help to understand the processes. If one country is the object of a shock right after a neighbouring country experienced a similar shock, it is useful to know whether the country has internal problems that justify the new perception, or whether the second country has been thrown into the same lot, as investors shoot first and ask questions later. The answer to that question is important because it may influence policy choices. But that is still different from preventing contagion ex ante, which is very difficult.

Does that mean that nothing can be done? I would say no. We can do something to foster strong financial intermediaries and a strong financial sector. One of the messages of 1998, when we had tens of billions of dollars of losses that were spread around the global financial system, was that you had a system that actually held up rather well given the stress that it was under. Again, I want to emphasize that with the losses that were distributed to the major intermediaries in the global financial system, the fact that the system held up as well as it did is very positive. But that was only possible because we have institutions that were very well capitalized and that were able to absorb a hit.

In contrast, the late 1980s and early 1990s saw the United States in recession; we faced the headwind caused by a credit crunch, because financial institutions were simply not as strong at that time. In other words, if you accept my notion that contagion is difficult to prevent, then you must have a market infrastructure that is sufficiently robust to absorb the stresses that may happen upon it.