Central bank tools to address market dysfunction in light of the 2020 “dash for cash”

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Frankfurt, 3 March 2021
Liquidity of euro investment grade corporate bonds

Source: Union Investment estimate based on proprietary data (lhs), IMF Global Financial Stability Report, October 2015 (rhs)

Regulation and balance sheet constraints hurt dealers

IMF survey on reasons for changes in market making in debt securities

Source: Union Investment estimate based on proprietary data (lhs), IMF Global Financial Stability Report, October 2015 (rhs)
Eurosysten asset purchases were meant to deal with the “dash for cash” but also to ease financing conditions in the wake of the pandemic.

Massive but short intervention in the United States
Monthly Federal Reserve net asset purchases, in billion US dollar

Measured and protracted intervention in the euro area
Monthly Eurosystem net asset purchases, in billion euros

Note: For the euro area, 10yr yield refers to the GDP-weighted ten-year sovereign yield (SDW time series key FM.M.U2.EUR.4F.BB.U2_10Y.YLD), and to a proprietary proxy of this series with daily values.
Source: FRBNY, ECB, Bloomberg, Union Investment.
Problems and potential solutions

What are the issues?

• The steady rise in assets under management at regulated euro-denominated bond funds that allow daily redemptions has not been met with a commensurate increase in market liquidity.
• In the wake of the Global Financial Crisis of 2008/2009, regulators inhibited proprietary trading and increased dealers’ inventory costs, but didn’t mandate central clearing of all bond trading. The result is the worst of both worlds: an OTC market with curtailed intermediation capacity.
• Large-scale asset purchases by central banks suppress market volatility, distort dealer positioning and reduce the incentive for credit analysis in normal times, since market participants can always offload their positions to a price-insensitive buyer. The resulting complacency can give way to heightened market volatility in reaction to any shock.

What can be done?

• Regulated investors should be encouraged to diversity into investment funds with longer dealing cycles such as ELTIFs for the portion of their financial assets that does not require daily liquidity (such as pension savings).
• Regulators should either mandate central clearing of all bond trading (as proposed by Darrell Duffie) or strengthen the OTC market by facilitating proprietary trading and risk taking by broker-dealers.
• Central bank should pre-commit to self-liquidating interventions aimed at restoring market function (cf. Andrew Hauser’s proposal). Central banks should thus become market makers, but not buyers of last resort.
• Central banks should clearly separate purchases aimed at reducing market distortions, e.g. by targeting low volatility, from purchases aimed at increasing market distortions, e.g. by targeting a desired level of yields or financing conditions.
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