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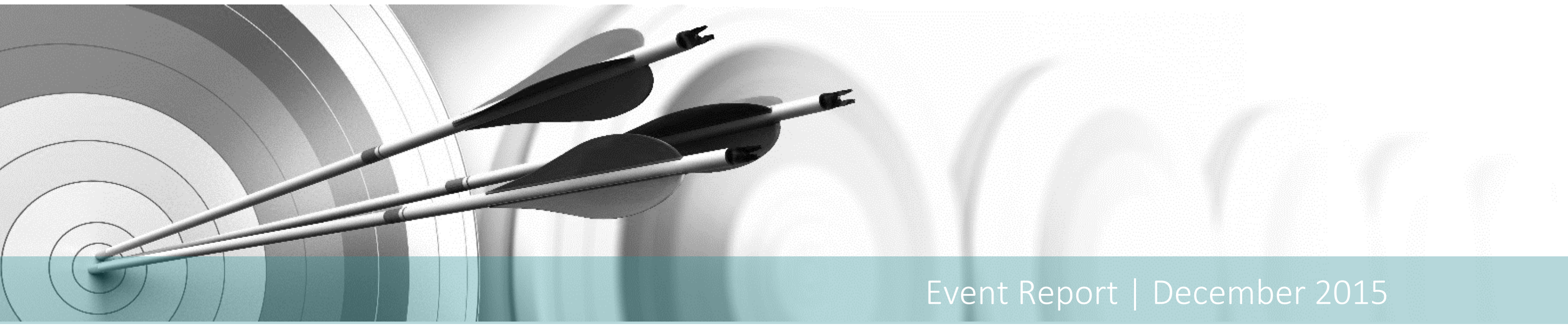

Global financial markets liquidity: Is it running dry?

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Context

The sudden drying up of market liquidity as the financial crisis took hold and various subsequent liquidity events in recent years showed the complexity of policy responses to preserve favourable market liquidity conditions. Today's combination of monetary stimulus, low interest rates environment, and strong asset values would suggest that financial markets may enter into a path of long-term structural changes. Current levels of market liquidity do not seem alarmingly low, but a decline in market liquidity in some financial instruments has risen doubts about the direction of this process. On the one hand, tighter regulations and balance sheet constraints seem to have prompted major banks to change their business models and shrink their trading inventories. On the other hand, asset managers, insurance companies and pension funds have been increasing their holdings of higher yielding, riskier financial instruments.

How has market liquidity evolved in key advanced and emerging markets in recent years? What cyclical and structural factors have driven these developments? What is the importance of post-crisis regulatory reforms across banking and capital markets compared to monetary policy actions? Have these reforms, some of which are yet to be implemented, already induced

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changes in the trading and investment behaviour of market participants? Does the highly accommodative monetary policy stance conceal the build-up of fragilities? Is there conclusive evidence of market liquidity deterioration in certain market segments (e.g. fixed income) due to the scaling back in the dealers' trading activities?

Stakeholders' views

The PwC study reviewed liquidity trends and prospects across a broad range of financial instruments and issuers, using a series of liquidity metrics, such as tightness, depth, breadth, resilience and immediacy. Mr. Forrest explained that some markets remain as liquid as before the financial crisis, whereas fixed income markets, especially in corporate bonds, reported recent deterioration. The overall analysis, which took into account structural, cyclical and regulatory factors, pointed towards continued downward pressure on market liquidity in the coming years. In general, it was found that most market participants are experiencing, and consequently adapting to a more difficult environment for market liquidity, with reduced bank trading activity in fixed income, evolving market structures and new trading behaviour. It was also indicated that worsening liquidity conditions have the potential to feed into higher costs of finance and hedging activity.

With reference to a liquidity risk assessment recently performed by ESMA, Mr. Winkler explained that market volatility went down across many asset classes in the post-crisis period until mid-2014, when the trend was broken. Nonetheless, the causation is very difficult to establish given the confluence of multiple liquidity drivers as well as the emergence of sudden market events. He emphasized that more progress needs to be made with respect the measurement of market liquidity in many asset classes.

Prof. Kirilenko argued that the market-making business model is currently under stress. Trading platforms are effectively competing through technology and innovation with the traditional providers of these services. While the system is transitioning towards new models of liquidity provisioning, one should also allow for different market strategies to be experimented by market markers provided that additional safeguards are put in place.

On the impact of pre- and post-trade transparency on liquidity in the fixed income space, Mr. Panigirtzoglou stressed that replacing the request-for-quote (RFQ), the dominant trading method in fixed income, with the central limit order book (CLOB), the dominant trading method in equities, would not work as swiftly in practice as one would expect. In his view, regulators and policy makers should encourage buy side investors towards playing a more important role in market making and liquidity provision.

Conclusion

Banking and capital markets regulation will have a significant but not definitive impact in the near future. Fundamental structural changes are already underway and will continue. Market liquidity risk is also partially masked by extremely loose monetary policy but this has the potential to change dramatically once monetary conditions come back to normal.

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