Navigating Monetary Tightening Through Fragile Markets: Introductory presentation

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The role of the bond market

“I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.”

James Carville, February 25, 1993  (Wall Street Journal)
Introduction

• Well-functioning financial markets are vital for stable funding of the real economy and an effective conduct of monetary policy
• 2022 saw unprecedented global tightening of monetary policy
• Losses in global stocks and bonds in 2022 exceeded $30tn, highest since the global financial crisis (GFC) in 2007/2008
• Stress emerged in many segments of financial markets, ranging from highly risky (crypto) to supposedly "safe assets" (UK gilts)
• Given fragility in many markets, unique set of concerns for central banks in Europe and North America is emerging

• **Purpose of this presentation:** Overview of market environment, recent structural changes and policy challenges for central banks
Turbulent end of low-rate era: Three themes for today

- Since GFC: Loose monetary policy = low rates and Quantitative Easing (QE)
- Global trend of rising valuations: Hunt for yield -> Prices of many traded/private assets steadily rising since 2000s (“bubble in everything”)
- Growth of private asset markets and non-banks (e.g. trading firms)
- Infrastructure (“Plumbing”) of markets also changing: Electronic trading replaces bank-centred markets; Increased central clearing leads to mechanical margining of volatility and “dash for cash” to pay margin calls
- Policy Challenge: Tightening monetary policy while preserving financial stability
- Key concern (and a main theme for today): Support resilience of market functioning, in particular for bond market
1. The long-run view of asset prices: US case

Data source: SDW
1. Current valuations challenged by rising rates

- Prudent portfolio management requires investors to discount future cash flows with realistic risk premia and consider risk-return trade-off

- Last decade brought us many cases of “irrational exuberance”:
  - Tech bubble (e.g. WeWork episode)
  - Crypto (“the bubble of a generation”)
  - Valuation of private assets, e.g. Venture Capital and Private Equity (→ is high premium of private investment vs stock market sustainable?)
  - Housing: A bubble in certain countries = “sitting on a volcano”?

- After initial tightening, strong optimism of market participants about Monetary Policy path has recently led to loosening of financial conditions in major economies
2. Zooming in on selected structural changes

• Key changes in “plumbing” of financial markets:
  - Growth in Non-Banks who entered lending, asset management and trading (fostered by low rates)
  - Fragmented intermediation and changed liquidity provision: Electronic trading centred on trading firms (=non-banks) is replacing bilateral intermediation by bank Dealers (e.g. US corporate and Treasury bonds; US / EU bond futures)
  - Central counterparties (CCPs) lead to mechanical margining of volatility (a driver of GameStop equity volatility and UK gilt stress last year)

• GENERAL IMPACT: Faster (e.g. High Frequency trading in US Treasury bonds), but rising liquidity risk -> both funding liquidity (need to pay margin calls; funding more expensive with higher rates) and market liquidity (can’t sell government bonds)
2. Growing non-bank financial sector in US and also in EU

- **Total assets of non-banks**: Almost doubled over last decade and now exceed SSM banks
- **NBFIs** have been key actors in US and UK government bond stress
- **Systemic role of non-banks also highlighted by energy stress** (e.g., utilities)
- **Policy question**: Hidden leverage and liquidity risks?

**Share of non-bank credit to NFCs in the euro area**

(Q1-1999 – Q2-2022)

![Graph showing share of non-bank credit to NFCs in the euro area from Q1-1999 to Q2-2022. The data shows a steady increase with significant contributions from 2008 onwards.](image)

Data source: ECB ("Financial Integration and Structure in the Euro Area", 2022)
2. Bond market: Who provides market-making?

- “Balance sheet space is treated like expensive real estate, available only to positions that can afford to pay rental fees that are now much larger.” (Duffie, 2018)
- Bank dealers are moving from market making to match making
- Active electronic trading
- Non-bank Dealers = “Principal Trading Firms” grow strongly
- Bank Dealers still dominate Dealer-Client trading
2. Stress in UK gilts

What happened? “Dislocation” in gilt trading

- Market for “safe asset” is fragile (cf. US Treasury in March 2020)
- **Cause:** Fiscal policy shock by new UK government leads to very high volatility
- **Margin calls** to LDI Pension Funds -> non-banks forced to sell gilts to raise cash but constrained intermediaries: Many sellers but too few buyers and pressure on intermediaries
- **End result:** BoE intervention (QE to mitigate side-effects of earlier QE, ie PF risk taking)

Implications

- Main ingredients also relevant for EU: Political risks, non-bank traders vulnerable to liquidity risks, Monetary Policy tightening and fragile bond market structure (OTC primarily)

Data source: Bloomberg
3. Numerous policy challenges for central banks

- Policymakers and investors facing a highly challenging market environment
- Monetary policy: Strong investor optimism vs continuing risks for price stability (e.g. wage pressures, inflation in services vs goods)
- Post-GFC financial system has recently weathered two large shocks: Covid in 2020 and inflation / energy in 2022
- No globally systemic event so far, but several stress events in last decade ("tantrums")
- Financial stability policy to tackle e.g. liquidity risks at non-banks
- In parallel to financial stability and monetary policy also climate risk as a vital new concern for policymakers: “Sticking to our knitting”? 
3. Managing Central Bank footprint in bond market

- Central banks acting resolutely to bring inflation back to target
- Rising policy rates, but also tapering of bond purchases
- Around $27 trillion of bonds held by Fed, ECB, Bank of Japan, Bank of England and Swiss National Bank in 2022 (before GFC holding ~ $4 trillion)
- Effect of QE: Fed owning ~ 30% of all US Treasuries; Eurosystem around 40% of euro area public debt
- Bond market now facing headwind = challenging imbalance of demand / supply: High and rising public debt burden in EU and US but central banks withdrawing their support for bond market -> Rising pressure on intermediaries = “Dealers”
- Case study: Japan = Managing inflation and a bond yield cap with very high debt burden?
3. Fragile market liquidity in government bonds

Data source: Bloomberg
3. What about resilience of Dealer banks?

Data source: Z. He
3. Direct impact of rising IR on CBs

• Rising rates directly affect central bank balance sheets: Paying more on banks’ reserves plus mark to market losses on bond portfolios bought via QE

• “The Fed’s balance sheet now appears similar to that of a hedge fund whose long-term assets are financed by short-term liabilities, except that such funds routinely hedge their interest rate risk whereas the Fed’s portfolio is effectively “naked.”” (Levin and Nelson, 2022)

Data source: St Louis Fed
3. Ongoing work on financial stability (e.g. FSB)

- **Goal:** Strengthen decentralised intermediation in bonds *(In parallel: Very extensive work on monetary policy)*
  - **CCPs:** Reduce pro-cyclicality in margin calls to avoid “dash for cash”
  - **Bank Dealers:** Adjust Leverage Ratio to reduce balance sheet burden?
  - **Market structure:** “All to all” trading and central clearing of cash bonds
  - **Transparency:** Publish comprehensive data on transactions
  - **Central Banks:** Review design of “Market Maker of last Resort”
  - **NBFIs:** Tackle NBFI leverage, OEF and MMF vulnerabilities
3. Policy challenges: TRANSITION TO PANEL

Darrell
- How can we make the UST market “safe”?
- Does rising electronic trading increase systemic risk?
- Key challenges for risk management in the current environment

Dan
- Do banks hold enough capital given the current risks?
- What can regulators & supervisors do in the current environment to increase systemic resilience [how can stress testing help]??
- Any additional observations on US environment and policy challenges?

Peter
- QE: A „dangerous addiction“
- What are the links between Monetary Policy, Financial Stability and fiscal policy and how do they affect central banks’ fight against inflation?
- Any additional observations on EU environment and policy challenges?