EUROPEAN CENTRAL BANK

EUROSYSTEM

***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)

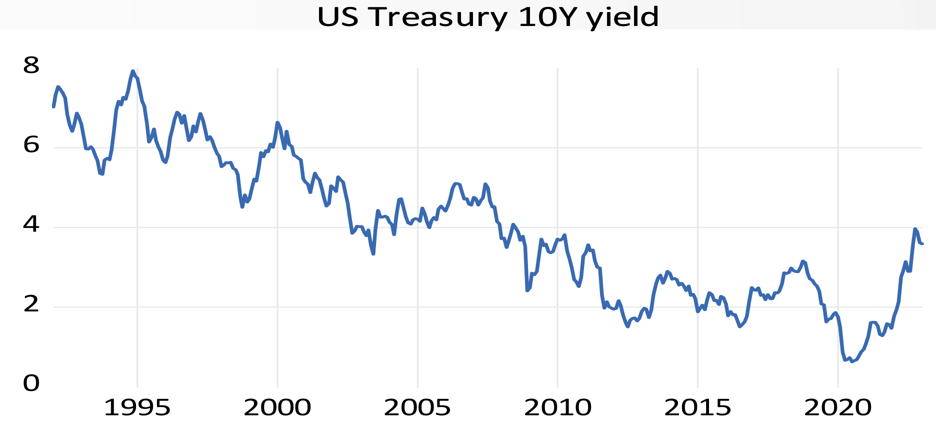
Introduction

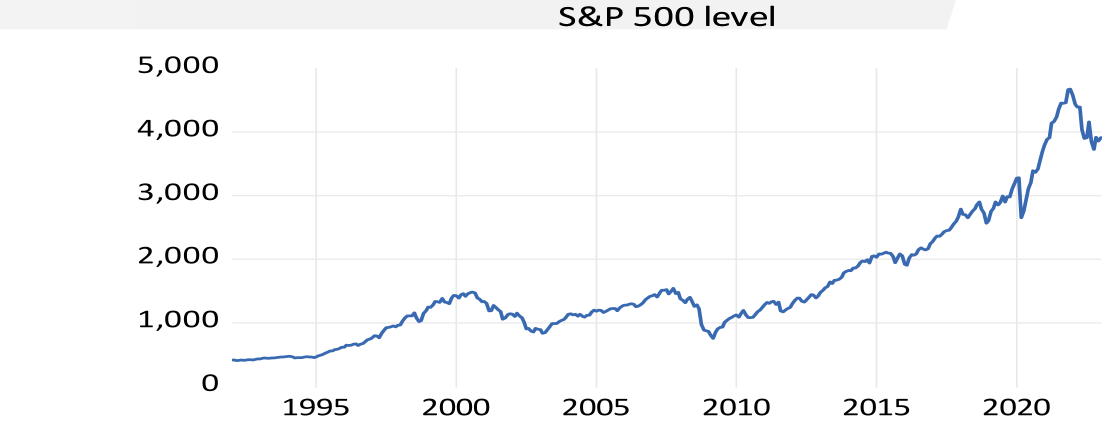
- Well-functioning financial markets are vital for stable funding of the real economy and an effective conduct of monetary policy
- 2022 saw unprecedented global tightening of monetary policy
- Losses in global stocks and bonds in 2022 exceeded $30tn, highest since the global financial crisis (GFC) in 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

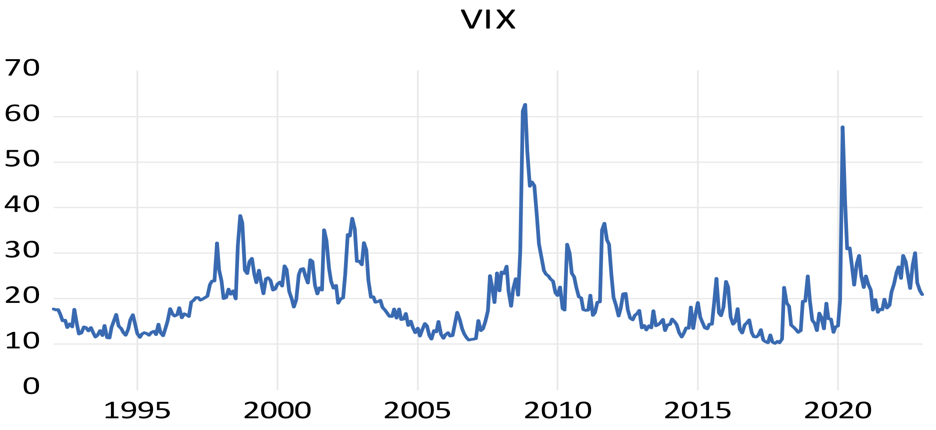
Turbulent end of low-rate era: Three themes for today

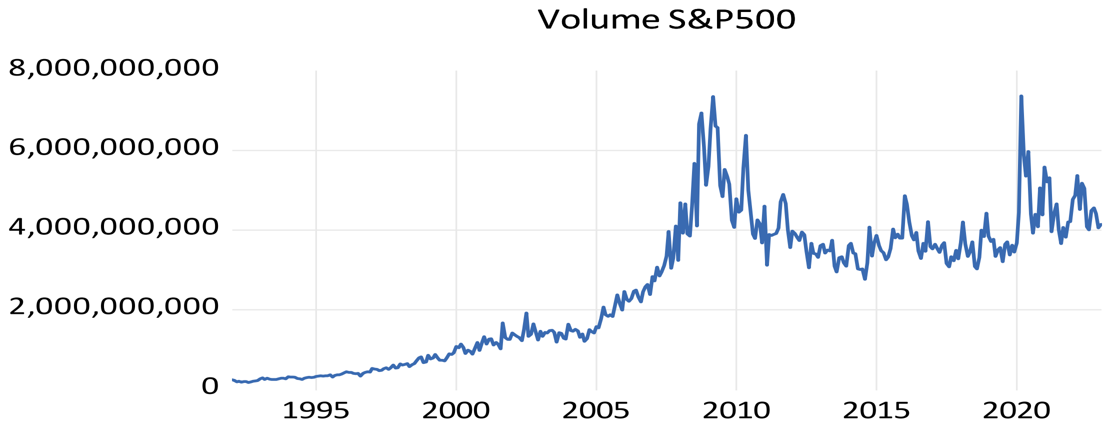
- **Since GFC: Loose monetary policy = low rates and Quantitative Easing (QE)**
- **Global trend of rising valuations: Hunt for yield -> Prices of many traded/private assets steadily rising since 2000s ("*bubble in everything*")**
- **Growth of private asset markets and non-banks (e.g. trading firms)**
- **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

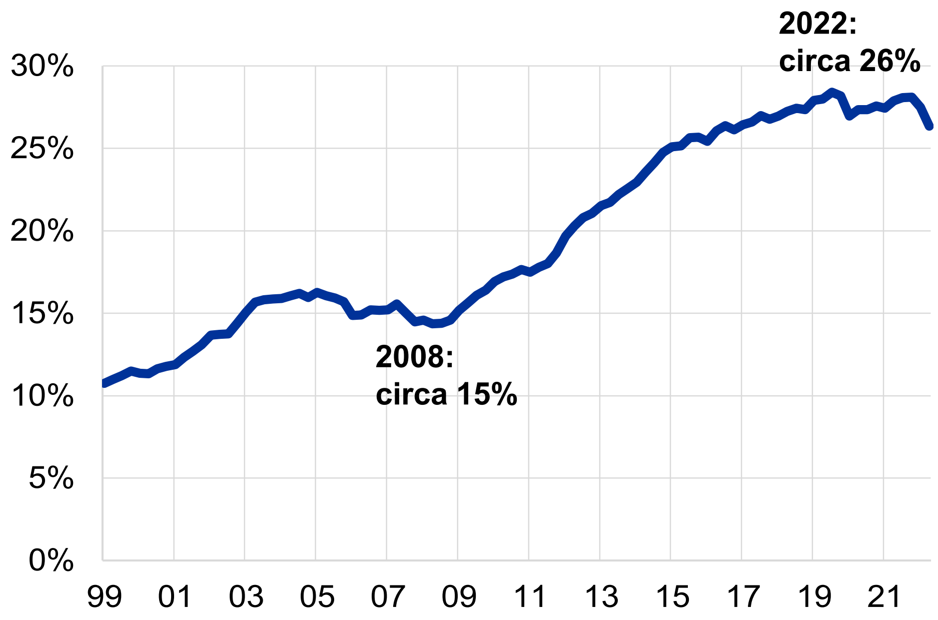
- **Key changes in "plumbing" of financial markets:**
  - Growth in **Non-Banks** who entered lending, asset management and trading (fostered by low rates)
  - Fragmented **intermediation** and changed liquidity provision: Electronic trading centred on trading firms (=non-banks) is replacing bilateral 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

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

(Q1-1999 – Q2-2022)



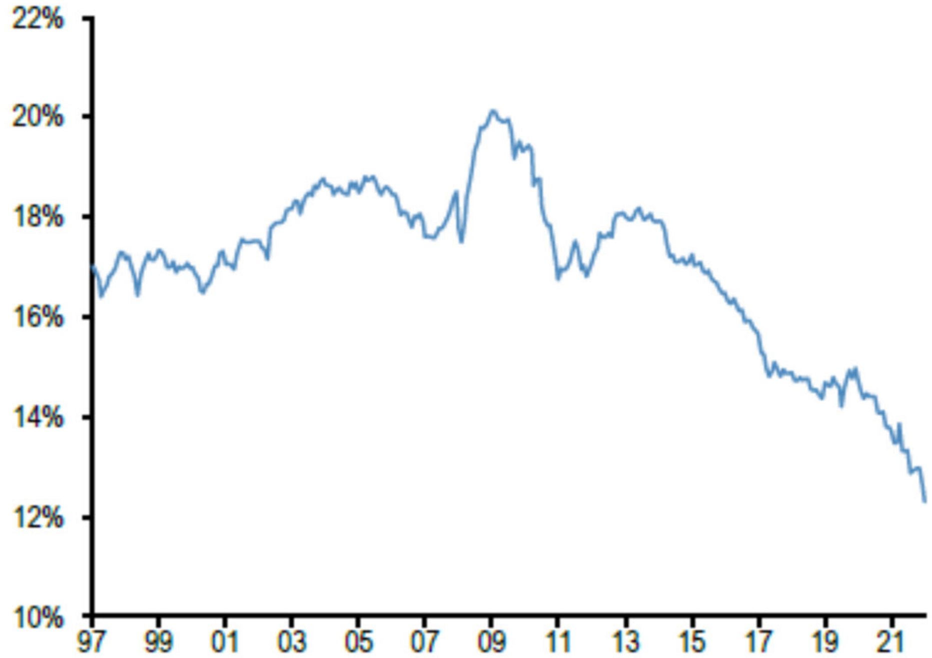
Data source: ECB (“Financial Integration and Structure in the Euro Area”, 2022)

- **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?**

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

EA banks' bond holdings as % of TA

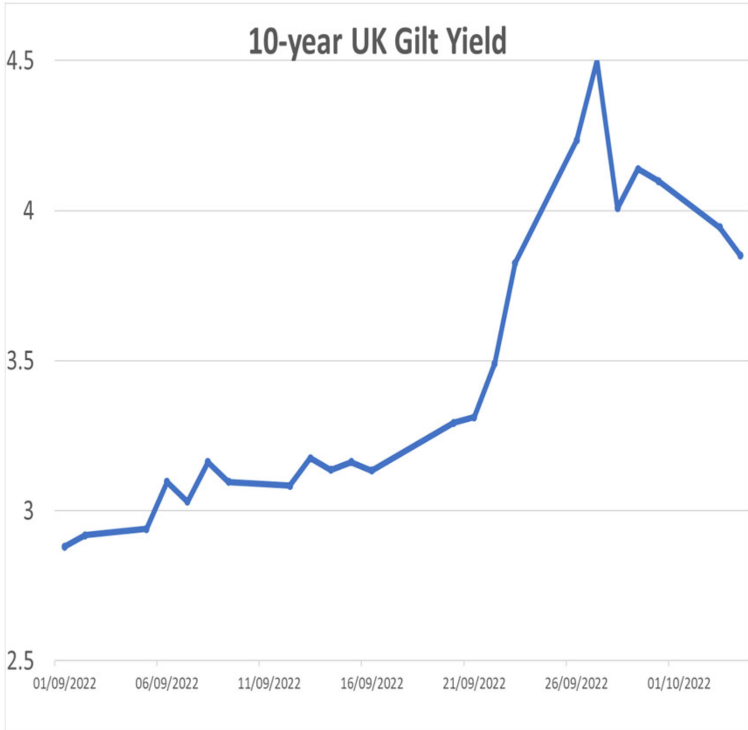


Source: ECB, J.P. Morgan.

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

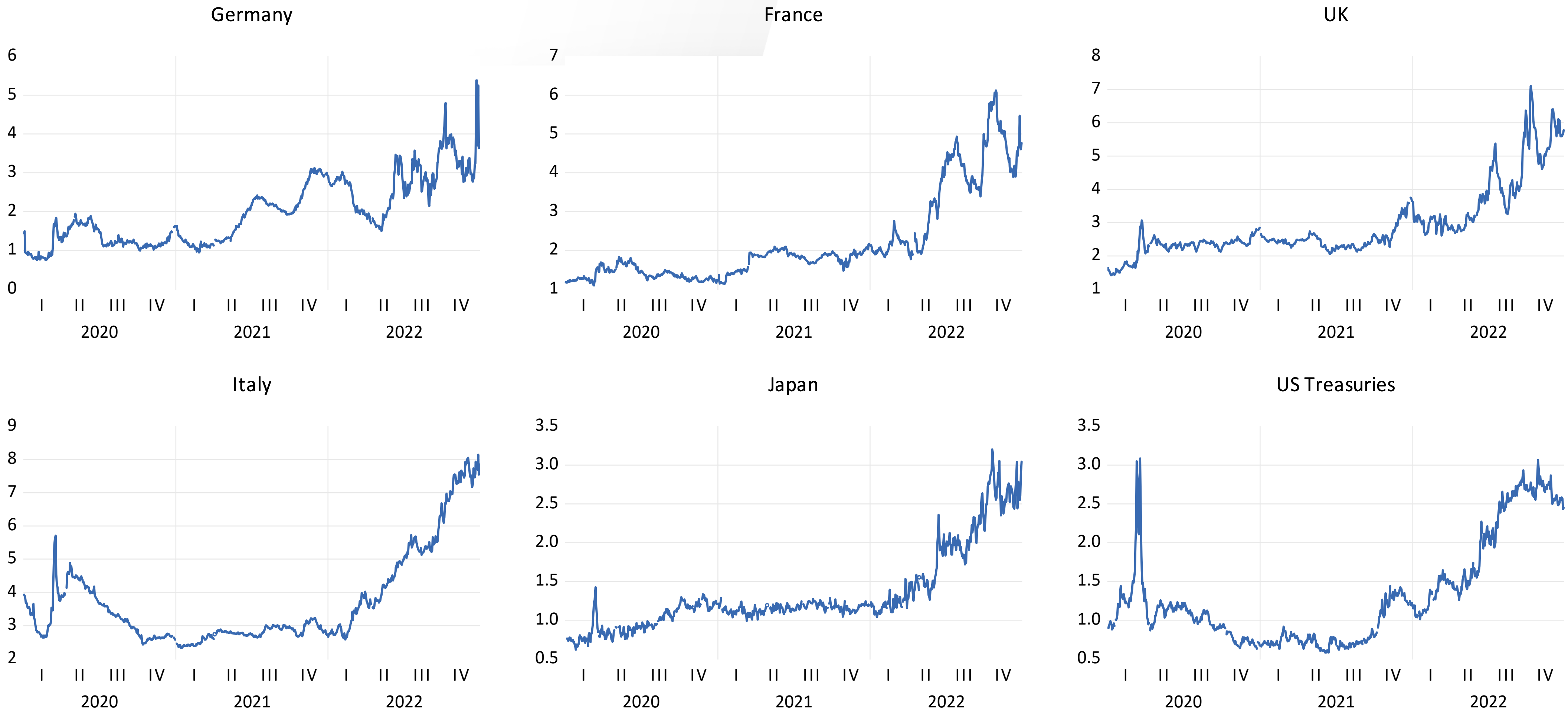
3. Numerous policy challenges for central banks

- **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

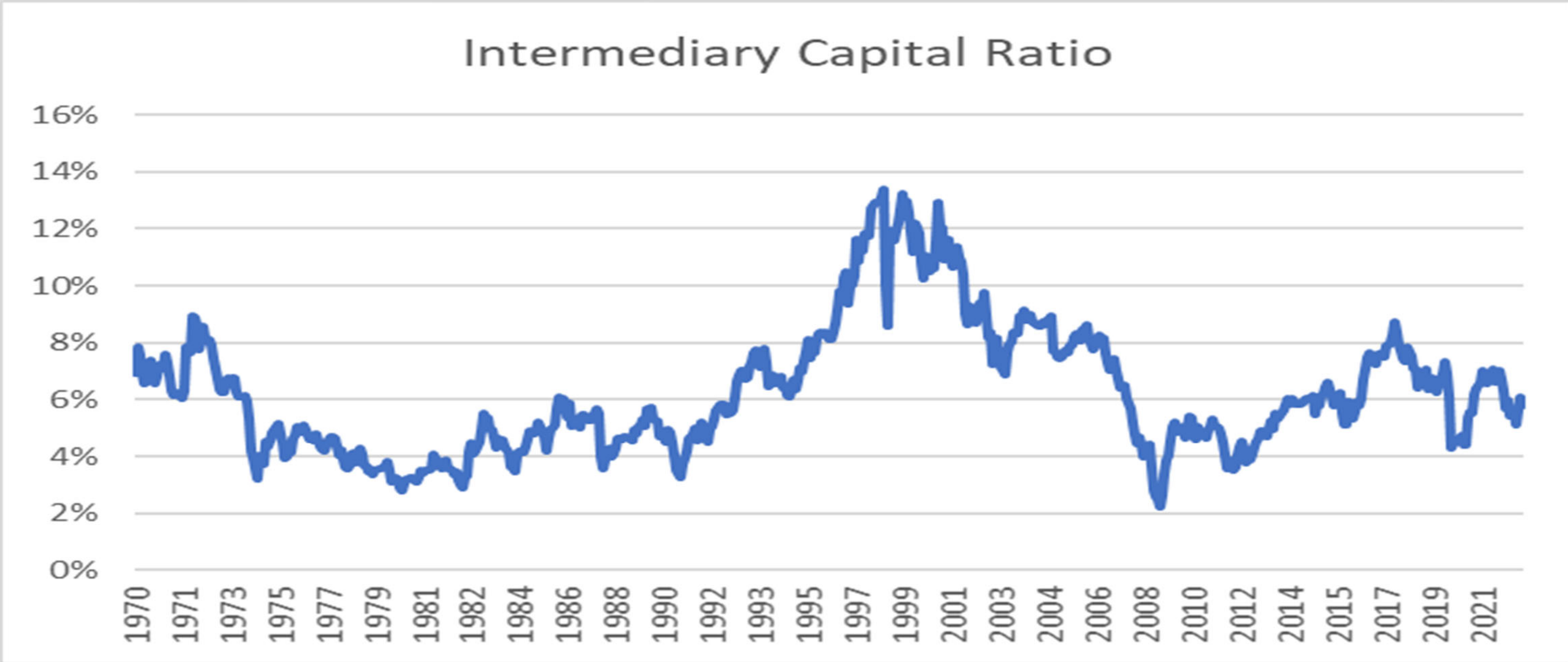
- **Central banks acting resolutely to bring inflation back to target**
- **Rising policy rates, but also tapering of bond purchases**
- **Around $27 trillion of bonds held by Fed, ECB, Bank of Japan, Bank of England and Swiss National Bank in 2022 (before GFC holding ~ $4 trillion)**
- **Effect of QE: 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

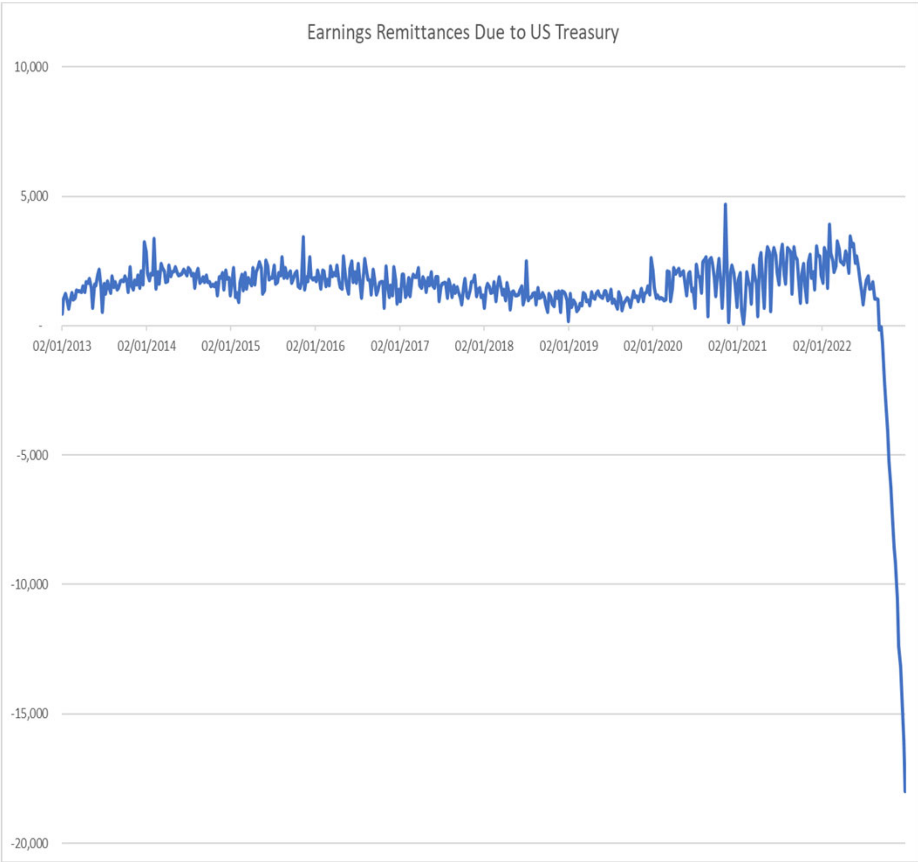
3. What about resilience of Dealer banks?



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?