SUERF
THE EUROPEAN MONEY AND FINANCE FORUM

newsletter
Summer 2015

Liquidity and Market Efficiency – Alive and Well?

Insights from the conference jointly organised by SUERF and the Bank of Finland
Helsinki, 3 July 2015

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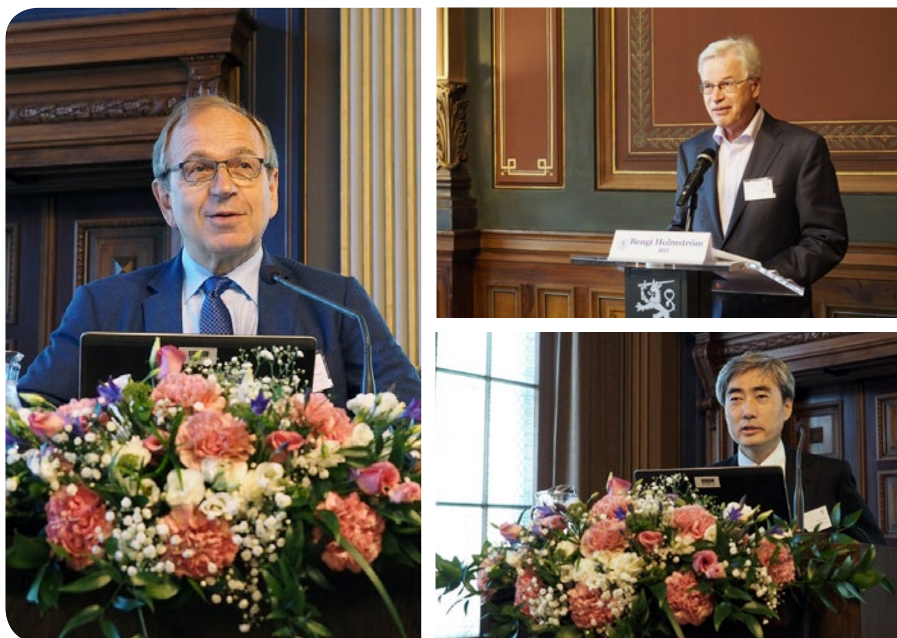

(l-r): Governor Erkki Liikanen, Professor Bengt Holmström (MIT), Hyun Song Shin (BIS)

Conference Report

By Esa Jokivuolle, Bank of Finland and SUERF

On 3 July 2015, SUERF organized its sixth joint conference with the Bank of Finland in Helsinki. The theme was liquidity and market efficiency. The one-day program consisted of six presentations (including three keynotes) and a lunchtime address.

As **Governor Liikanen** pointed out in his opening speech, the recent financial crisis has given a serious blow to the doctrine of market efficiency. At the same time the need has arisen to better understand liquidity which evaporated in the midst of the crisis.

When planning the conference, the organizers had been inspired by the thoughts of **Bengt Holmström** (MIT) on how liquidity and market efficiency may be linked. In his lunchtime talk, Professor Holmström laid out his argument that liquidity in stock and debt markets, especially in short-term money markets, are maximized under very different conditions regarding the information content of market prices.

We are used to the fact that in the stock market, transparency of information promotes market efficiency and symmetry of information is good for liquidity. Liquidity in debt markets also requires symmetry of information, but in this case it is a different kind of symmetry. Liquidity in debt markets arises from sufficient overcollateralization of debt so that no one has an incentive to become informed of the exact value of the collateral securing the debt. As a result, liquidity in debt markets flourishes during symmetric ignorance. The downside of this is that debt market crises may take us by surprise. Professor Holmström said that in a sufficiently severe macro level crisis there is always a role for the government to step in to provide liquidity. Only the government can provide for the ultimate risk sharing in such situations.

In the first keynote, **Hyun Song Shin** (BIS) talked about global liquidity in terms of cross-border bank and non-bank financing. Using the BIS statistics he showed the central role of US dollar-denominated financing which is not confined to originate from within the US borders. For example, prior to the financial crisis European banks were major intermediaries of US dollar funds. After the crisis, non-banks are providing more of the dollar-denominated funding. The high dependence on the dollar in international financing creates a channel whereby dollar-local currency exchange rate fluctuations affect the strength of borrower balance sheets and hence potentially risk-taking, investment, and growth. He suggested that the dollar-exchange rate mechanism and the increased role of non-bank financing may pose a new way in which future market disruptions may take place. This would be in addition to the standard leverage channel which was central in the most recent crisis.

Tuomas Välimäki (Bank of Finland) took the audience through the changes in monetary policy operations in the Eurozone from its start until recently. One of his key points was to explain how the full allotment central bank lending policy was adopted during the financial crisis. His own research has been instrumental in this regard.

Petri Jylhä (Imperial College Business School) provided direct evidence on the causal link from funding liquidity to market liquidity by studying market price reactions to a US regulatory change in options' margin requirements. By utilizing this quasi-experiment he was able to support the theories developed in the context of the recent financial crisis that funding conditions partly drive market liquidity, also in normal times.

The second keynote was provided by **George G. Pennacchi** (University of Illinois) who argued that developments in corporate taxation, by favoring debt relative to equity, can help explain how the historical share of banks and non-banks in liquidity provision has varied in the US. Another important driver of banks'

George G. Pennacchi, University of Illinois at Urbana-Champaign

Erkki Liikanen with Peter Fisher, Dartmouth College and BlackRock Investment Institute

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liquidity provision has been development in banks' public safety net such as central bank liquidity provision to solvent banks which may suffer from bank runs, and, eventually, deposit insurance. His model helps understand how growth in money market mutual funds and securitization of loans have coincided in the US over the past forty years. As policy responses to tackle the tax-induced distortions in liquidity provision, he favors Belgian style tax deductions for equity or appropriately-designed contingent convertible (CoCo) securities to be accepted as part of banks' regulatory capital.

The effects of regulation on risks and liquidity were also discussed in the presentation by **Jussi Keppo** (NUS). Regulation should always be justified by that it corrects for a certain market failure. In practice, it will also have side effects, and it may be circumvented. Designing good regulation is about being effective, and striking a balance between solving the market failure and limiting side effects.

In this spirit, Professor Keppo had studied the announcement effects of the US Volcker rule on banks' risk taking and liquidity position. The results indicated that the rule may not become very effective: although the US banks have reduced activities banned by the rule, banks have also reduced their hedging, leaving their original risk positions largely unaffected.

The day was completed with the third keynote by **Peter Fisher** (Dartmouth College and BlackRock Investment Institute) who discussed the role of central banks, addressing the present policies against historical background. He was concerned about risks stemming from the low interest rates environment and the quantitative easing policies. He thought it was possible that low, even negative yields of central bank liabilities may have induced hoarding of other high-quality assets among private agents. According to him, this does not constitute a normal state of liquidity and market efficiency. When asked what central banks should generally do, he suggested more weight should be given to financial stability issues. He said their focus has been too much on solely finding a good macroeconomic equilibrium.

End of Report

SUERF would like to thank Bank of Finland for the generous hospitality and the successful organization of the event.

Esa Jokivuolle and Jouko Vilmunen (Bank of Finland), Urs W. Birchler (SUERF)

The conference presentations are available for download on the SUERF website at:

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