Unconventional wisdom: How will unusual monetary policy affect market liquidity?

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Views are of the author only and not of the IMF
Pledged collateral received by U.S. banks
Pledged collateral received by European banks (and Nomura)
Collateral from Hedge Funds –
(single biggest source of pledged collateral to market)

- Hedge funds pledge collateral for reuse to their prime broker (PB) in lieu of **financing from the PB** (or, rehypothecation)

  **note:** **cross-border issue:** In the U.S., SEC’s Rule 15c3 and Regulation T generally limits PB’s use of rehypothecated collateral from a client. Non-US jurisdictions such as UK (English Law) or EU do not have any limits.

- Hedge funds also fund their positions via **repo(s)** with dealers

- HF collateral “to the street” from PB and repo was about $1.7 trill (2007); down to about $1.35 trill after crisis. Recently with AUM growing sizably, leverage rebounding, collateral from HF to street about $ 1.9 trillion (2014); similar trend in 2015 with higher AUM.
The “non-hedge fund” source of collateral—

Securities Lending, 2007-2015

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</thead>
<tbody>
<tr>
<td>Securities Lending vs. Cash Collateral</td>
<td>1209</td>
<td>935</td>
<td>875</td>
<td>818</td>
<td>687</td>
<td>620</td>
<td>669</td>
<td>701</td>
<td>644</td>
</tr>
<tr>
<td>Securities Lending vs. Non-Cash Collateral</td>
<td>486</td>
<td>251</td>
<td>270</td>
<td>301</td>
<td>370</td>
<td>378</td>
<td>338</td>
<td>425</td>
<td>454</td>
</tr>
<tr>
<td>Total Securities Lending</td>
<td><strong>1,695</strong></td>
<td><strong>1,187</strong></td>
<td><strong>1,146</strong></td>
<td><strong>1,119</strong></td>
<td><strong>1,058</strong></td>
<td><strong>998</strong></td>
<td><strong>1,008</strong></td>
<td><strong>1,137</strong></td>
<td><strong>1,098</strong></td>
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</table>

source: RMA
Why is securities lending business not “bouncing back”—see article

- Legally akin to repos (except securities lent out can be “called” at any time)

- **Official sector** (central banks, sovereign wealth funds) are key players in this market along with **pension funds** and **insurers**. They usually liaise with the collateral desks of large banks via custodians

- However, sec-lending business has not bounced back to the pre-Lehman days: Why?
  - Balance sheet “space” at the large collateral banks
  - Opportunity to invest “cash” from sec-lending in a zero-rate environment
  - Near future, sale of AAA securities by EM, Japan, Mid-east…
Collateral Re-use—

see last column

# Table 2.3: Sources of Pledged Collateral, Volume of Market, and Velocity (2007, 2010-2014)

(In trillions of U.S. dollars; velocity in units)

<table>
<thead>
<tr>
<th>Year</th>
<th>Hedge funds</th>
<th>Others</th>
<th>Total</th>
<th>Volume of secured operations</th>
<th>Velocity</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>1.7</td>
<td>1.7</td>
<td>3.4</td>
<td>10.0</td>
<td>3.0</td>
</tr>
<tr>
<td>2010</td>
<td>1.3</td>
<td>1.1</td>
<td>2.4</td>
<td>5.8</td>
<td>2.4</td>
</tr>
<tr>
<td>2011</td>
<td>1.3</td>
<td>1.05</td>
<td>2.35</td>
<td>6.1</td>
<td>2.5</td>
</tr>
<tr>
<td>2012</td>
<td>1.8</td>
<td>1.0</td>
<td>2.8</td>
<td>6.0</td>
<td>2.2</td>
</tr>
<tr>
<td>2013</td>
<td>1.85</td>
<td>1.0</td>
<td>2.85</td>
<td>5.8</td>
<td>2.0</td>
</tr>
<tr>
<td>2014</td>
<td>1.9</td>
<td>1.1</td>
<td>3.0</td>
<td>5.8</td>
<td>1.9</td>
</tr>
</tbody>
</table>

An example of repeated use/reuse of collateral (that leads to collateral chains)

\[
\text{Demand} = \text{Supply} \times \text{re-use rate}
\]

Is there a fiduciary duty to issue safe assets by public sector? Why? (e.g., US Treasury’s debt issuance mandate: regular/predictable/least cost)
The current global Monetary Policy

- Central banks via QE are trying to rejuvenate the credit creation engine. So far they are not having great success.

- Monetary policy is ultra loose.

- Restricting collateral re-use is a tight money policy that seems to be **at odds** with the current policies of key monetary authorities. (cite regulatory examples/proposals)
QE resulted in Fed printing-- where is this money?

- The bank deposit market is sizable—in fact the top 4 bank holding companies (Bank of America, Wells Fargo, Citibank and JPMorgan) hold about $3.9 trillion in deposits as per FDIC’s June 2015 data, relative to $1.9 trillion as of June 2008.

- The top 50 bank holding companies hold $7.5 trillion as of June 2015, relative to $4 trillion as of June 2008.

- QE had not happened then deposits would have grown roughly in line with economy's growth and/or household wealth (these are low single digit rates)
The “old plumbing” ..... in blue area
Plumbing...... and central banks
— an example from Fed’s reverse repo program (RRP)
Change in Fed Balance Sheet since end-2007—a snapshot (and ECB is going this route)

Asset Purchases, change since 2007

$ 3.4 trillion approx

Excess Reserves (i.e. deposits of banks at Fed)

$ 2.9 trillion approx
Life below zero in Eurozone—policy rate and repo rate move in sync
Fed Dec 16 liftoff- sizable…can change the relative prices of money and collateral. Goal: GC will likely equal FF (at B)
Asset Sales: US Treasury is sold to market—GC near B (not exactly B) but will be a market signal

[Unlike large RRP, previous slide, that controls collateral]