Liquidity: where are we and two paradoxes

Arminio Fraga, Gávea Investimentos

1. Comments on Biais, Declerck and Moinas.

Biais et al. have written an excellent paper that makes creative use of micro data on exchange-trade stocks. The conclusions are interesting and I have no disagreements to report, only a couple of comments.

First, I tend not to be overly confident on the labelling of various types of investors, and suspect some of the conclusions on the profitability of certain groups may depend on the time horizon that one looks at.

Second, Issues related to the speed at which individual participant is able to trade are meaningful, but not entirely new (think of pigeons, the telegraph, the telephone, etc.). What seems to be more important are asymmetries of information, more on this ahead.

2. Current liquidity in markets is low.

Liquidity in equity markets as measured by turnover (i.e., volume traded divided by market capitalization) is lower than pre-crisis levels, especially when China is not included in the calculation.

Similarly, liquidity in the markets for government and corporate bonds is also low, down from the highs of recent years some 70% (governments) to 30% (high yield corporates). These are all over the counter markets.

3. Paradox 1: macro liquidity is high, but micro market liquidity is low.

While trading liquidity is lower than recent highs in almost all asset classes and markets, macroeconomic liquidity has never been higher, as indicated by extremely low or negative interest rates in Europe, Japan and the US, as well as by the sizable Quantitative Easing policies in these economies. Moreover, exchange rate intervention in most Asian markets adds up to roughly the same very large amount of asset buying by central banks as the QE policies of the advanced economies. Why then is market liquidity so low?

For starters, on government bond markets the massive outright accumulation of positions by central banks has driven down the availability and probably the liquidity as well, especially at the short end of the curve, a crucial source of safe and liquid assets in most economies.

Moreover, higher capital and liquidity rules, as well as restrictions on proprietary trading at banks, have probably contributed to the decline in trading liquidity.

An interesting issue to monitor is whether investors such as large mutual and hedge funds will take over the role of liquidity providers, probably yes, and how far they could go without attracting regulation. For larger issues, such as government bonds, this may well happen in organized exchanges.

The welfare implications of all this require further analytical work, an interesting and challenging task. Some aspects of this question are far from obvious. For example, in pre-crisis days market makers possibly took too much risk and benefited from observing the flows of customers. Therefore, it is not clear whether such lower liquidity (driven by less extreme risk taking and less asymmetric information) is welfare reducing.

4. Paradox 2: Liquidity is only there in quiet times, when not needed. Why?

Here the problem may be one of herding, driven by the extreme concentration of volume on a few large central banks and asset managers that leads to herd behavior, perhaps in turn driven by a collective focus on some key risk factors such as changes in monetary policy. Markets seem to be more and more characterized by smooth trends that last for a while but are interrupted by violent spikes.

Here the macro may be connected to the micro: the mispricing of liquidity and extremely large aggregate maturity mismatches (such as those that prevailed before the crisis of 2007/8, and may still prevail) may be the product of regulations such as formal and implicit deposit insurance, the availability of lender of last resort support and asymmetric monetary policies. This is a hot topic of research, and we have to think the BIS for all the good work it is doing in the area.