Faulty Plumbing: Market Liquidity and Recent Impairment

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What Drives Liquidity?

Liquidity = **Capital** * **Leverage** * **Trust**
- **Confidence**
- **Redemptions**
- **Fundamentals**

Today v. 2008:

- Capital stock is lower, though rebuilding.
- Leverage is vastly reduced.
- Several factors have recently damaged trust:
  - Specter of QE tapering
  - Regulation-mandated attenuation of bank balance sheets
  - Worsening macro fundamentals

These asset classes merit particular consideration:

- Local Currency Bonds
- Interest Rate Swaps
- Credit Default Swaps
- EM FX Options

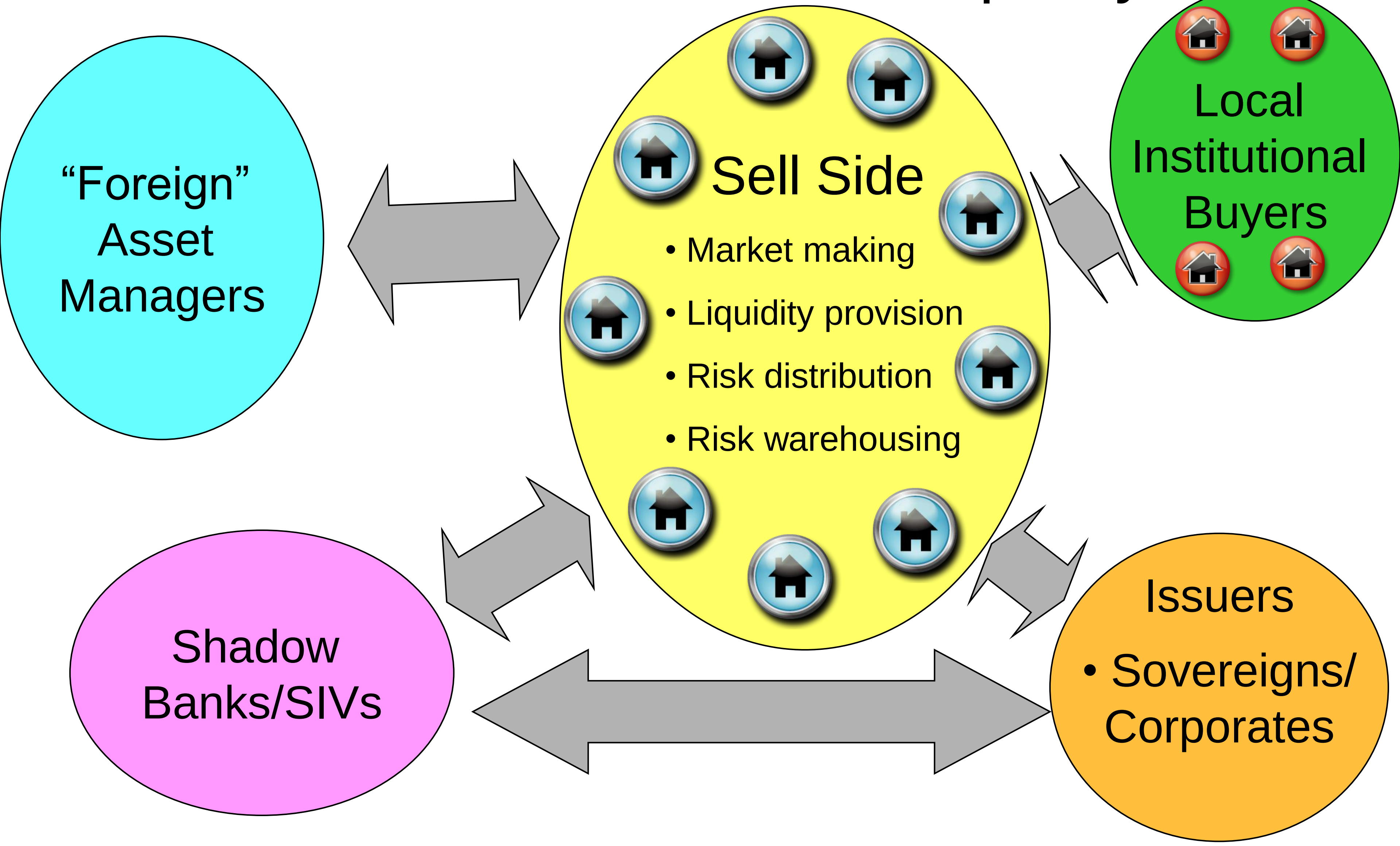
Trends Transforming the Landscape

- Dramatically enlarged participation of non-dedicated players
- Disappearance of shadow banking/synthetic credit

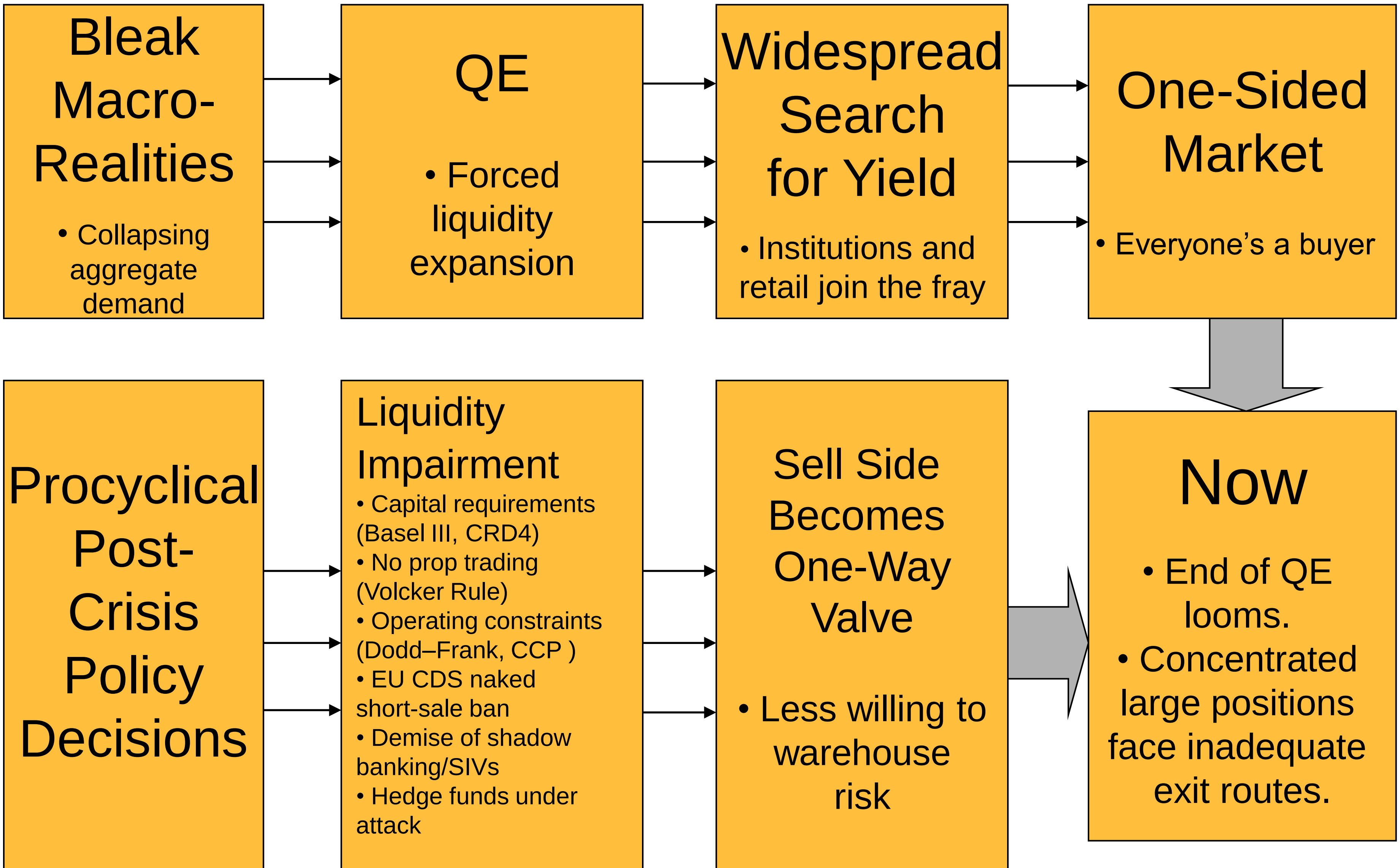
Liquidity and
Market Discontinuities

10-Year ZAR Swaps

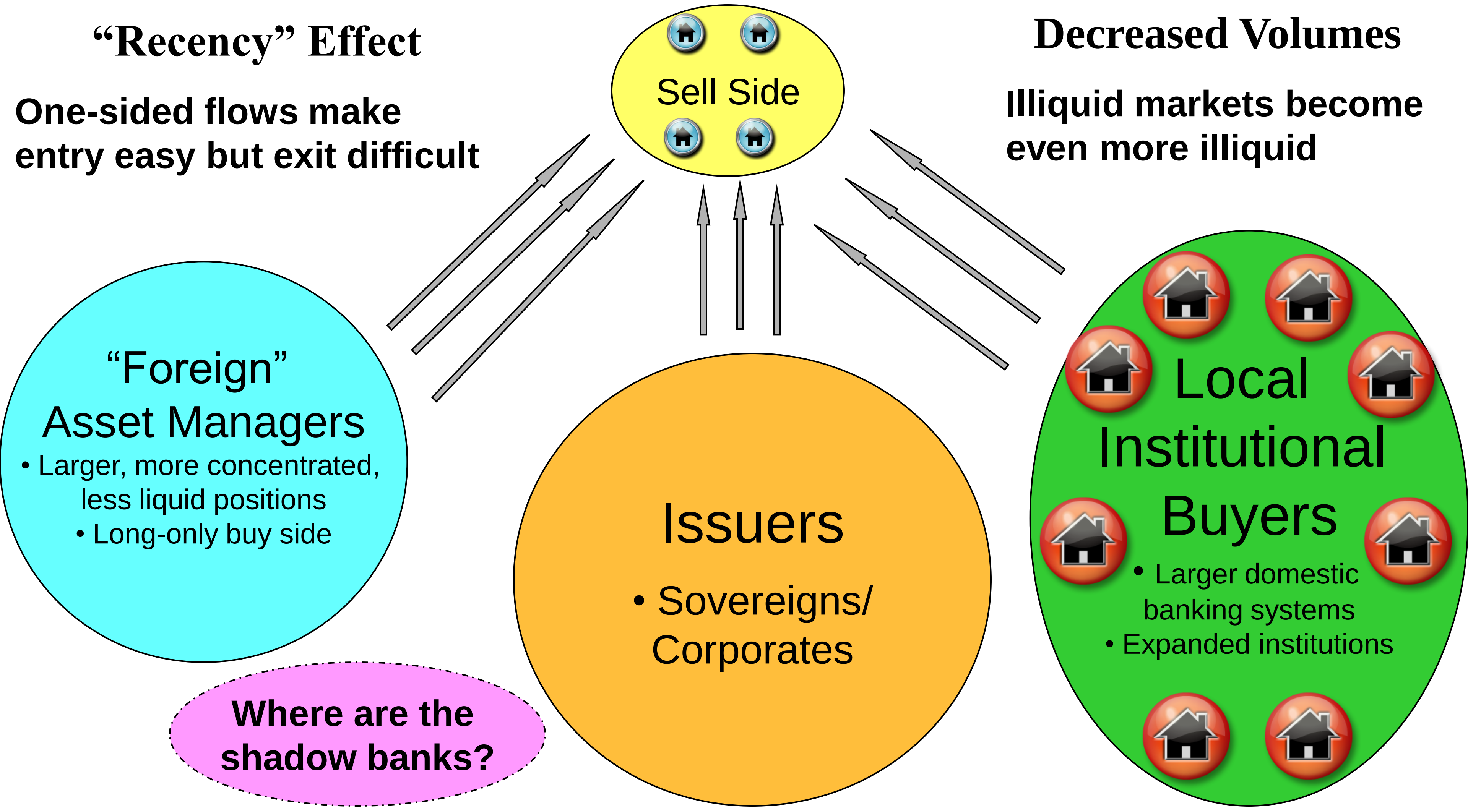
Pre-Crisis: Large, Diverse Banking Sector Provides Bidirectional Liquidity



Crisis Responses Catalyze Unintended Consequences



Now (QE World): Smaller, Consolidated Banking Sector Unable to Meet Liquidity Needs of Enlarged Market Players



Is the Solution a Paradigm Shift?

QE
Ends

Realities of
New
Regulatory
Regime

Fragile circumstances demand difficult choices.

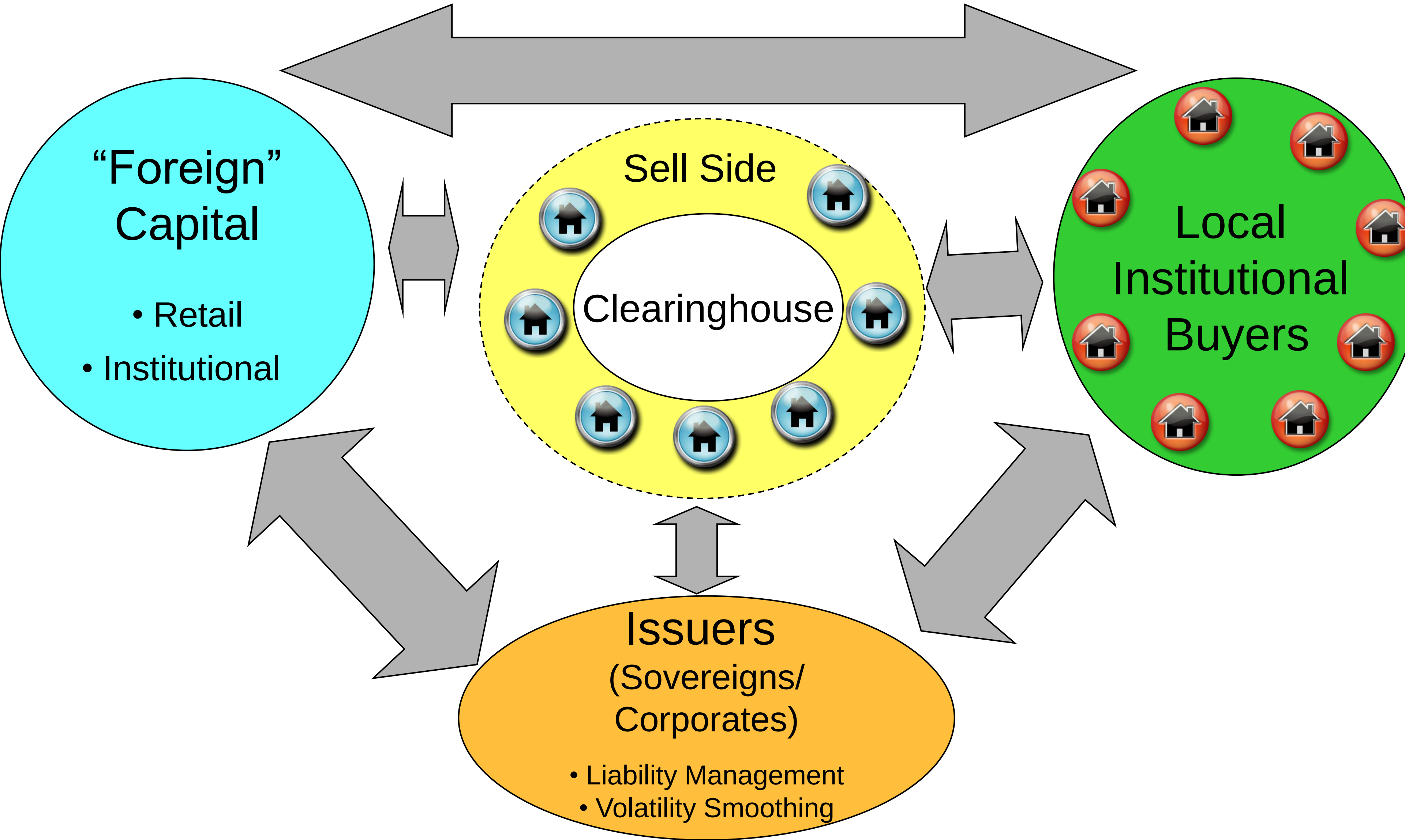
EITHER

1. New interconnections between players.
2. More active role for central banks and issuers (liability management, buybacks).
3. Regulatory forbearance and shift away from conception of “evil” hedge funds.
4. Involvement of retail.

OR

Leave it to the market – price clears.

Possible Solution: Interconnected Players of Comparable Size Enhance Liquidity



Points to Ponder

How will the IMF respond to this new strain of virus?

- Specific programs for countries plagued by inelastic current account balances?
- A special focus on turbulence in local-currency fixed income unrelated to macro fundamentals?
- A standardized regime for defaulting sovereigns?

- Shadow banking, for all its evils, provided speculative liquidity and shock absorption. What will replace it?

- Central banks have historically monitored FX volatility, but now must deal with interest rate volatility as well.

- Procyclical pension fund risk management further confounds the liquidity mix.
- Is expanded retail activity in all asset classes a necessary condition for liquidity improvement?