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Dealing with change: Liquidity in evolving market structures – speech by Minouche Shafik

In a speech to the AQR Asset Management Institute at the London Business School, Minouche Shafik, Deputy Governor for Markets and Banking, considers the causes and consequences of recent bouts of market illiquidity. The speech highlights how policymakers, infrastructure providers and market participants should respond to changing market structures.

The structure of financial markets is changing…

Minouche begins by highlighting that while the global system is awash with liquidity at the macro level, we hear many warnings that market liquidity is draining away at the micro level. Over the coming years, three of the major factors that have dominated markets since the financial crisis – accommodative monetary policy, private sector inflows to emerging markets, and official sector outflows in the opposite direction – seem set to change, and those "tectonic shifts" may pose a challenge to the functioning of markets.

Recent episodes of volatility, such as those following the sharp falls in Chinese equity markets in August, have been short in duration, heterogeneous in nature and have not jeopardised the continued growth of the real economy. But they do illustrate that "banks and non-banks' ability and willingness to put capital at risk… has changed".

Put another way: "although liquidity may on average be higher, the risk that liquidity may not be available when it is needed most has also risen". A prolonged period of volatility and illiquidity may result in a broader "rush for the exit" in widely held positions, precipitating a loss of confidence in the ability of financial markets to provide a reliable means of funding stable economic growth.

…as a result of regulation, risk awareness, evolution and innovation.

Minouche argues that "regulation is only part of the story" of underlying causes. The experience of the financial crisis gave banks greater *awareness of the risks* that were implicitly being run in the past. The reduction in the relative size of dealer balance sheets may also be a natural result of the processes of

evolution and *innovation* with the emergence of new players, venues and strategies. Minouche draws parallels with the currently changing business model of retailers, and the adoption of Just In Time management in manufacturing in the 70s and 80s, which emphasised efficiency, fewer inventories, and speed.

Policymakers, infrastructure providers and – most importantly – market participants must adapt.

How should we respond to ensure that the resilience and effectiveness of financial markets is maximised? Policymakers can support adaptation. For example, were liquidity to deteriorate to such an extent that it was judged to pose a systemic threat to financial stability or the transmission of monetary policy, the Bank would stand ready to provide liquidity to the financial system counter-cyclically. And market infrastructures should ensure that the use of stabilising mechanisms and transparency are regularly reviewed.

Ultimately, however, much of the responsibility for adapting to changes in market structure lies with those who determine prices: market participants. They must price liquidity appropriately, and manage it prudently. When making the decision to purchase an asset they should ensure that their investment horizon is aligned with the inherent liquidity of that asset. And they also need to understand that abundant market liquidity in normal times may not be indicative of the ease with which they can exit a position or effectively hedge it in times of stress.

Minouche concludes that when it comes to matters of market liquidity, the old adage “caveat emptor” or “let the buyer beware” should guide prudent market participants.

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