CHAPTER 2

MARKET LIQUIDITY—RESILIENT OR FLEETING?

SUMMARY

Market participants in advanced and emerging market economies have become worried that both the level of market liquidity and its resilience may be declining, especially for bonds, and that as a result the risks associated with a liquidity shock may be rising. A high *level* of market liquidity—the ability to rapidly buy or sell a sizable volume of securities at a low cost and with a limited price impact—is important to the efficient transfer of funds from savers to borrowers and hence to economic growth. Highly *resilient* market liquidity is critical to financial stability because it is less prone to sharp declines in response to shocks. Market liquidity that is low is also likely to be fragile, but seemingly ample market liquidity can also suddenly drop.

This chapter separately examines the factors that influence the level of market liquidity and those that affect its resilience, and finds that cyclical factors, including monetary policy, play an important role. In particular, the chapter finds that only some markets show obvious signs of worsening market liquidity, although dynamics diverge across bond classes. However, the current levels of market liquidity are being sustained by benign cyclical conditions—and some structural developments may be eroding its resilience. In addition, spillovers of market liquidity across asset classes, including emerging market assets, have increased.

Not enough time has passed for a full evaluation of the impact of recent regulatory changes to be made. Reduced market making seems to have had a detrimental impact on the level of market liquidity, but this decline is likely driven by a variety of factors. In other areas, the impact of regulation is clearer. For example, restrictions on derivatives trading (such as those imposed by the European Union in 2012) have weakened the liquidity of the underlying assets. In contrast, regulations to increase transparency have improved the level of market liquidity.

Changes in market structures appear to have increased the fragility of liquidity. Larger holdings of corporate bonds by mutual funds, and a higher concentration of holdings among mutual funds, pension funds, and insurance companies, are associated with less resilient liquidity. At the same time, the proliferation of small bond issuances has almost certainly lowered liquidity in the bond market and helped build up liquidity mismatches in investment funds.

The chapter recommends measures to bolster both the level of market liquidity and its resilience. Since market liquidity is prone to suddenly drying up, policymakers should adopt preemptive strategies to cope with such shifts in market liquidity. Furthermore, because current market liquidity conditions can provide clues about the risk of liquidity evaporations, policymakers should also carefully monitor market liquidity conditions over a wide range of asset classes. The chapter does not, however, aim to provide "optimal" benchmarks for the level or resilience of market liquidity. Market infrastructure reforms (including equal-access electronic trading platforms and standardization) can help by creating more transparent and open capital markets. Trading restrictions on derivatives should be reevaluated. Regulators should consider using tools to help adequately price in the cost of liquidity at mutual funds. A smooth normalization of monetary policy in the United States is important to avoid disruptions in market liquidity in both advanced and emerging market economies.

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CHAPTER 3

CORPORATE LEVERAGE IN EMERGING MARKETS—A CONCERN?

SUMMARY

The corporate debt of nonfinancial firms across major emerging market economies quadrupled between 2004 and 2014. At the same time, the composition of that corporate debt has been shifting away from loans and toward bonds. Although greater leverage can be used for investment, thereby boosting growth, the upward trend in recent years naturally raises concerns because many financial crises in emerging markets have been preceded by rapid leverage growth.

This chapter examines the evolving influence of firm, country, and global factors on emerging market leverage, issuance, and spread patterns during the past decade. For this purpose, it uses large, rich databases. Although the chapter does not aim to provide a quantitative assessment of whether leverage in certain sectors or countries is excessive, the analysis of the drivers of leverage growth can help shed light on potential risks.

The three key results of the chapter are as follows: First, the relative contributions of firm- and country-specific characteristics in explaining leverage growth, issuance, and spreads in emerging markets seem to have diminished in recent years, with global drivers playing a larger role. Second, leverage has risen more in more cyclical sectors, and it has grown most in construction. Higher leverage has also been associated with, on average, rising foreign currency exposures. Third, despite weaker balance sheets, emerging market firms have managed to issue bonds at better terms (lower yields and longer maturities), with many issuers taking advantage of favorable financial conditions to refinance their debt.

The greater role of global factors during a period when they have been exceptionally favorable suggests that emerging markets must prepare for the implications of global financial tightening. The main policy recommendations are the following: First, monitoring vulnerable and systemically important firms, as well as banks and other sectors closely linked to them, is crucial. Second, such expanded monitoring requires that the collection of data on corporate sector finances, including foreign currency exposures, be improved. Third, macro- and microprudential policies could help limit a further buildup of foreign exchange balance sheet exposures and contain excessive increases in corporate leverage. Fourth, as advanced economies normalize monetary policy, emerging markets should prepare for an increase in corporate failures and, where needed, reform corporate insolvency regimes.

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