Last resort market making in gilts

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26th April 2023

Outline

1. Liquidity problems in government securities markets.
   i. Role of dealers and official market makers.
2. Two recent episodes of illiquidity
   i. March 2020 – coronavirus.
   ii. September 2022 – Truss/Kwarteng.
3. Upcoming issues:
   i. Sustainability of government finances.
   ii. Reversing quantitative easing.
   iii. Likely recurrence of illiquidity episodes.
4. Contingency planning for last resort market making.
   i. Objectives.
   ii. Issues.

1. Liquidity problems in government securities markets

Market liquidity = ease of selling without disturbing price.

Important for governments to be able to borrow easily: they need market liquidity.

Importance of market makers, or dealers. They need capital, and 'official market makers' are nearly all regulated banks. Other dealers (e.g. hedge funds, high-frequency traders) aren't committed to participation.

History:

- Government borrowing usually explodes in wartime: public finances are unsustainable without drastic post-war adjustment.
- In UK, market liquidity was inadequate in and after WW2.
- Supplemented from early 1950s by Bank of England making markets.
- Need to support market makers both as MMLR (continuous, early 1950s – 1986) and as supplier of capital (occasional, 1952, 1957, 1960, 1964, 1967).
- Conflict between market making in gilts and implementing monetary policy: not satisfactorily resolved until early 1980s.
- Risk of fiscal dominance of monetary policy (= threat to price stability as well as financial stability). Link to market liquidity.

1 i Official market makers and all-to-all trading

All-to-all trading means any investor can trade with any other. ATA trading has always been legally possible in UK, but official market makers have been protected. The real issue in the UK is the protection provided to them:

- Exclusive access to auctions and other DMO operations.
- Post-auction option facility.
- Status attracts clients.

But:

- GEMMs say the business is unprofitable.
- Regulatory issues: leverage ratio, interest rate exposures.

Reasons for not protecting official market makers:

- In good times, ATA trading promises lower costs of trading to investors, and government, and more market liquidity.

Reasons for protecting official market makers:

- They have to maintain monitored market making functions at all times. Can't temporarily withdraw.
- In bad times, greater risk of market dysfunction without official MMs. How much greater depends on how committed the official market makers really are.

Q. What are 'good' and 'bad' times? Suggested A. Bad times are when price discovery is difficult, e.g. because of uncertainty about fiscal policy (e.g. fiscal dominance?), or volume of sales. At such times, market makers must be ready to warehouse unsold bonds.

OECD 2016 survey:

- In practice, all or nearly all debt management agencies designated official market makers.
- Many sovereign issuers said liquidity had deteriorated.
- Concentration of issuance on benchmarks, syndications, regular and predictable issuance, bond exchanges, buy-backs, STRIPS, official securities lending, lending or repo facilities for official market makers

ARIEL project in 1970s: Bank of England refused to deal in gilts on platform outside Stock Exchange because of absence of dedicated market makers.

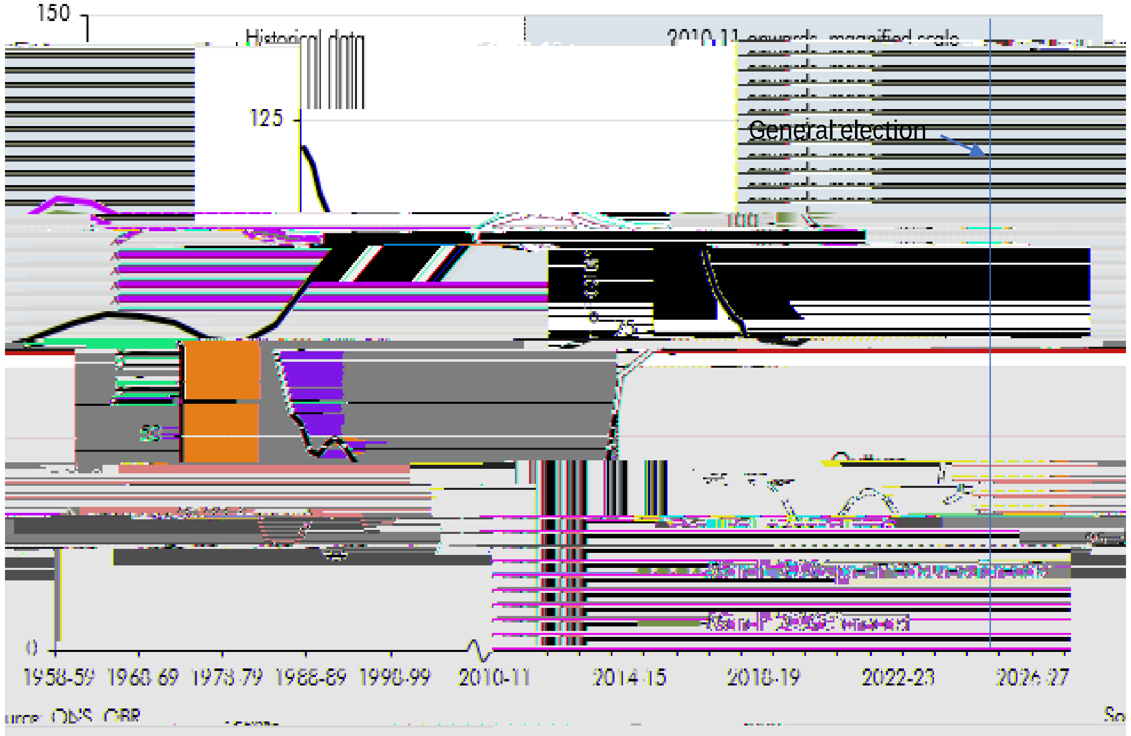
2 i Episode 1: March 2020: onset of coronavirus

- Unwinding of large positions in US Treasury and other government securities overwhelmed capacity of market makers. Treasury markets were not as liquid as previously thought.
- Risk of sharp rise in yields and/or inability of government to issue bonds.
- Central banks, including Bank of England Monetary Policy Committee, chose to respond with much more QE (equivalent of 20% of GDP in UK). Why?
  - To maintain market liquidity, as they made clear.
  - In pursuit of the inflation target, by holding yields down. No announced yield target, but obviously the MPC thought that market-determined yields would be too high.
  - B of E and DMO prefer the role of price-takers, even if they are price makers.
- Bond sales net to market initially very small. Monetary financing of government in effect though not in intention.
- Not really MMLR because a market maker buys and sells. In 2020 – 2021 central banks bought and bought. It was an unacknowledged and loose form of yield curve control.
- In effect maturity of debt was shortened: variable-interest-rate deposits in central banks replaced fixed-interest-rate bonds.
- B of E Financial Policy Committee wasn’t involved.
- Precedents – USA and UK (WW2 and after), Operation Twist (1961), Japan (QQE).
- Inflation? Yes.

2 ii Episode 2: Truss/Kwarteng

Liz Truss appointed leader of Conservative party and Prime Minister by party members 6th September 2022, having promised tax cuts despite already-large budget deficit.

3 i Fiscal sustainability (March 2023, i.e. post Truss/Kwarteng).



Debt/GDP and tax/GDP ratios have both been rising and are both relatively high by historical standards: debt/GDP is 101% now compared with 36% in 1997.

3 ii Reversing QE

QE in the UK:

Nearly all asset purchases were government bonds – gilts, > 3 years when bought.

Total peaked at £895 bn at end of 2021: 35% of GDP.

3 iii British government bond sales 2019 - 2024

£ billion	Gross sales by government	Maturities	Net sales by government	Gross purchases by B of E (QE/QT)	Net purchases by B of E (QE/QT)	Gross purchases by market	Net purchases by market
2019/20	137	99	38	55	23	81	15
2020/21	485	98	388	345	326	141	62
2021/22							
2022/23							
2023/24							

Big deficit + B of E sales will lead to need for very large sales of bonds in 2023/24.

Risk of strain on market infrastructure, especially the capacity of the market makers to warehouse bonds between auctions and the emergence of demand, and especially if government finances appear unstable.

4 i Contingency planning for MMLR - objectives

Gilt market liquidity dried up in March 2020 (Covid) and September 2022 (fiscal policy). There is a high risk that market liquidity will dry up again. Market liquidity could become chronically inadequate, as in 1942 – 1986.

4 ii Contingency planning for MMLR - issues

- Needs to be a backstop, and not crowd out commercial market makers.
- Should it be a standing facility (as in 1950s – 1980s), or an occasional one (as in 2020 and 2022)?
  - It could not be kept secret as in 1970s and 1980s.
  - Standing facility would be more transparent, because there wouldn’t need to be discretionary decisions about when to make it available, but it would need periodic reviews. Parameters would need to be adjustable in an emergency.
- MMLR operations force the central bank and government debt managers to be price makers.