Conference produces no solution for Treasury market shocks

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The annual US Treasury Market Conference held in New York on Wednesday, comprising officials from the Fed, the US Treasury and the Securities and Exchange Commission, pointed to a series of significant problems in the $22 trillion market for US debt that have emerged over the past decade, but failed to advance any solution.

The discussion centred on the report by the Inter-Agency Working Group for Treasury Market Surveillance (IWAG) earlier this month on the crisis that erupted in March 2020 when the Treasury market effectively froze. This was an event that is never supposed to happen in what is touted as the deepest and most liquid market in the world.

As the IWAG report noted, the disruptions were "driven by heavy sales during a period when many had expected a flight to safety to bolster the demand for Treasury securities." The "normal" situation is that in times of turbulence US government debt is bought as a "safe haven."

But in March 2020 there was a "dash for cash" and Treasuries were sold off with the result that at one point there were no buyers for government debt. After several days of crisis, which saw a plunge on Wall Street, financial markets were only stabilised following intervention by the Fed to the tune of trillions of dollars.

While the onset of the pandemic was the trigger for the crisis, it was not the underlying cause. There had been two previous incidents which sparked considerable concerns in financial regulatory circles.

In October 2014, the Treasury market experienced an unexplained "flash rally" when for a 12-minute period bond prices rose, and yields fell dramatically. There was no news event that could explain the movement and it was concluded there must have been a significant change in the way the market was functioning.

As a result, a conference on Treasury market functioning met in 2015 and has convened annually since then.

A second major incident took place in September 2019, well before the pandemic appeared on the scene, when interest rates in the repo market experienced significant spikes requiring major interventions by the Fed.

The repo market is a very short-term market, often overnight, in which traders raise cash by depositing assets with lenders which they subsequently buy back at a slightly elevated price—the difference representing the interest rate. The repo market is important because it is a mechanism through which investors, particularly hedge funds, finance their big bets in financial markets.

In his remarks to Wednesday's conference, John Williams, the president of the New York Fed, recalled the events of March 2020 and the earlier turmoil of 2014 and 2019, noting that "when disruptions have been sufficiently severe and persistent, the market has not been able to sufficiently correct without official-sector intervention."

What he called the "incipient breakdown" in March last year quickly spread to other segments of the US and global financial system and risked a pull-back in the availability of credit essential for the functioning of the economy. The speed and scale of official intervention was "truly unprecedented," he said.

"At the New York Fed, we are used to talking in very large sums, but even for us the figures were staggering. We were offering overnight repos of up to $1 trillion, as well as substantial amounts of term repos of longer maturities."

Williams pointed to some of the changes that have taken place over the recent period, in particular the rise of electronic trading which means that financial markets are increasingly interconnected and turbulence in one area can rapidly travel through the rest of the system.

"When the Treasury market breaks down, when trading is disrupted, or when interest rates move in ways that are not based on fundamentals, the ripple effects can be swift—and devastating to the flow of credit to businesses and households."

Williams concluded his remarks by noting that "three episodes of market dysfunction over the past decade are too many." He called for the best minds to come together to discuss Treasury market reform.

The chairman of the Securities and Exchange Commission (SEC), Gary Gensler, began by describing the disruptions in the Treasury market as "especially jarring."

He pointed to significant changes in the market associated with the development of electronic trading over the past two decades and the growth of the market itself. As the IWAG report drew out, in 2007 Treasury debt was $5.1 trillion, or one-third of GDP, but grew to $21.6 trillion at the end of 2020, or 101 percent of GDP.

Over this time, so-called high-frequency trading firms have assumed greater importance and now account for between 50 and 60 percent of market activity. These firms, however, are not subject to the same levels of regulatory oversight as the group of 24 banks known as primary dealers that have been the backbone of the market.

In an example of how attempts to reform one sector of the financial system give rise to problems in another area, the banks play a lesser role than in the past because regulations, introduced in response to the financial crisis of 2008, have reduced the amount of debt they can hold on their balance sheets.

Gensler suggested that financial trading firms be required to register with the SEC so their activities could be more closely monitored.

He also advocated for a central clearing house which would "sit in the middle as the buyer to every seller and the seller to every buyer," replacing thousands of bilateral relationships with a hub and spokes model.

The Under Secretary for Domestic Finance at the US Treasury, Nellie Liang, provided details on the size of Treasury market transactions.

"There is no larger thoroughfare for global capital than the US Treasury market, which averages over $600 billion every single day, with high volume days easily surpassing $1 trillion," she said.

Liang noted that the market had been relatively stable since March 2020, but if this was "the end of the story, we would not be meeting each year at conferences like this." The Treasury market was changing continually.

She said while expanded central clearing "appears promising in terms of potential improvements in risk management," consideration had to be given to its possible problems, "such as increased concentration of risk at the central counterparty."

Like the other participants, Liang offered no solution to the crises that have erupted, saying that she looked forward to future discussions.

It brought to mind climate change conferences where the representatives conclude that global warming is an existential threat and is so important that they will meet again to discuss it next year.

Reviewing this latest deliberation on the financial system, together with others that have preceded it, one also cannot help but recall the remarks of Marx in the *Communist Manifesto* as he likened the bourgeoisie to "the sorcerer, who is no longer able control the powers of the nether world whom he has called up by his spells."

In this case the "spells" have consisted of the "forward guidance" by the Fed and other central banks, assurances they will keep up the inflow of money into the financial system—a total of at least $23 trillion since 2008—that has fuelled the speculation at the source of the continuing and intensifying financial storms.