Trouble brewing in $24 trillion US Treasury market

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Over the past month, the eyes of the financial world have been focused on the turmoil in the UK. But there is growing recognition that a potentially bigger crisis is building up in the US.

It centres on the $24 trillion US Treasury market, where government bonds are bought and sold daily and which forms the basis of the global financial system.

There are warnings that the conditions that led it to freeze in March 2020, when for several days there were virtually no buyers for US bonds, supposedly the safest financial asset in the world, are returning.

This is reflected in the tightening of liquidity. Liquidity refers to the ease with which deals can be made.

An article by *Financial Times* columnist Gillian Tett, published at the end of last week, noted that while surface conditions in the market for US Treasury bonds appeared calm, in contrast to the turmoil in the UK, beneath this "surface veneer, some nasty currents are swirling in the Treasuries world."

An index of Treasury market liquidity compiled by JPMorgan has deteriorated to levels not seen since the March 2020 crisis.

The extent of the problems was highlighted in an article published earlier this month by the executive editor of Bloomberg Opinion, Robert Burgess, in which he pointed to "what is rapidly becoming a potential crisis in the world's most important market—US Treasuries."

"The word 'crisis' is not hyperbole," he wrote. "Liquidity is quickly evaporating. Volatility is soaring. Once unthinkable, even demand at the government's debt auctions is becoming a concern."

Along with other commentators, Burgess referred to the comments by US Treasury Secretary Janet Yellen in response to a question following a speech she delivered in Washington last week. Yellen said her department was "worried about a loss of adequate liquidity in the market."

She noted that while the capacity of broker dealers in the Treasury market had not expanded that much, the overall supply of government debt had climbed.

This issue was the subject of a statement issued by the Treasury Department last month. It said that in the period from 2007 to 2022 the debt held by the public increased from $5.1 trillion to over $23 trillion.

But over the same period the rise of electronic trading and the "expanded participation by proprietary trading firms" brought with it a 50 percent decrease in the central clearing of deals. In other words, an increasing amount of activity is taking place in areas of the market outside the sight of financial authorities.

"This reduction in market visibility carries implications for systemic risk, especially in the context of market disruptions," the statement said, pointing to the March 2020 crisis and the events of February 25 last year "when the prices of Treasures dropped sharply amid strained liquidity conditions."

One of the main factors at work in the worsening liquidity situation is interest rate hikes by the Fed. Another is so-called quantitative tightening (QT) in which, rather than buying up government debt, the Fed is now running down its holdings to the tune of $95 billion a month. Whereas the Fed's bond buying program under quantitative easing (QE) increased liquidity, QT is decreasing it.

Burgess also pointed to another drain of liquidity. The "most powerful buyers of Treasuries—from Japanese pensions and life insurers to foreign governments and US commercial banks—are all pulling back at the same time," he wrote.

This situation is being compounded by the rise of the

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US dollar against the Japanese yen and the intervention of Japanese authorities in the market to try to prevent a further slide by selling dollar assets.

A recent paper by economists Raghuram Raja, the former governor of the Bank of India and Viral Acharya of New York University focused on how QT was affecting market liquidity.

As a result of the reduction in the Fed's asset holdings, "we could have a problem of liquidity stress in the banking system," Acharya told the FT last month. "And whenever banks are stressed, it usually spreads over to non-banks and Treasury markets and other [funding] markets."

The Bank of America has warned that strains in the Treasury market could be "one of the greatest threats to global financial stability today," potentially worse than the housing market bubble of 2004-2007 which sparked the 2008 crisis.

Last week, the *New York Times* reported that Fed officials have been quizzing Wall Street experts about whether a crisis like that in the UK could occur in the US. The Biden administration is conducting its own research and has been given the same message: "The risk of a financial crisis has grown as central banks have sharply raised interest rates."

The article said that although the market was not "breaking down," it was hard to quickly find a buyer for US government bonds, and "in corners of finance that involve more complicated investment structures, there's concern that volatility could trigger a dangerous chain reaction."

The *Times* reported that Biden "has pressed his team to estimate the likelihood that the United States could experience another 2008-style shock on Wall Street."

Another area of concern is so-called emerging markets because the rise of the dollar has increased the payments they have to make on their dollar-denominated debt and whether this worsening situation, and the increased risk of defaults, could rebound on the US.

As Tett noted in her article, there are attempts by US regulators to deal with worsening liquidity in the Treasury markets and there will be a top-level meeting next month to discuss structural reforms. Some of these had already been made, including forcing more of the market trades onto centralised clearing platforms.

"But the ugly truth is that these reforms are still proceeding at far too timid and slow a pace to remove the structural risks, particularly given that QT is plunging us into uncharted waters," she wrote.

Tett expressed the hope that next month's meeting of regulators would forcefully accelerate the pace of reform.

"If not," she concluded, "QT could create even more liquidity stress, and mean that …[the] British turmoil could eventually be a prologue to a much bigger American drama if (or when) new economic shocks hit."

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