CHANGES IN MARKETS AND CENTRAL BANK STRATEGIES

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HOW US TREASURY MARKET CHANGES ARE SHAPING CENTRAL BANKS' STRATEGIES

By Nikhil Sanghani, Managing Director,
Economic and Monetary Policy Institute, OMFIF

US Treasuries form the backbone of global financial markets and are a critical component of central bank reserve managers' portfolios. It is widely recognised as a deep, liquid and safe asset, but the Treasury market is being transformed by changes in policy, regulation and structure. OMFIF, in partnership with BNY, hosted a discussion on this key issue – and the implication for reserve managers – at the sidelines of the International Monetary Fund-World Bank meetings in Washington DC in October.

There were 48 attendees including 17 representatives from central banks globally, as well as representatives from major international organisations such as the IMF, World Bank and Bank for International Settlements.

The event began with remarks from Laide Majiyagbe, head of financing and liquidity at BNY, who presented the findings of a BNY paper on 'The importance of safety and liquidity in the U.S. Treasury market'. This research was co-authored with Nate Wuerffel, head of market structure at BNY, who provided additional insights as part of a panel discussion.

The panel also consisted of Min Soo Kwon, deputy governor of the Bank of Korea, Katarzyna Zajdel-Kurowska, director of asset management and advisory at World Bank Treasury and Olaf Sleijpen, executive board member of monetary affairs and financial stability at De Nederlandsche Bank.
The session was moderated by David Marsh, OMFIF's chairman and chief executive officer.

Market Changes

The discussion initially centred on how US monetary and fiscal policy is restricting dollar liquidity. It was noted that the Federal Reserve's quantitative tightening process is draining liquidity from the private sector. Meanwhile, a persistent federal budget deficit is leading to higher Treasury issuance, with the outstanding size of US debt estimated by the Congressional Budget Office to hit over $50tn in the next decade. Absorbing this additional debt into the market, potentially at higher rates, may also sap liquidity.

The panel discussed that there are already signs of liquidity pressures in funding markets in month-end periods. Further pressures are arising from regulatory changes too. It was noted that post-2008 financial crisis, the pandemic 'dash for cash' have led many banks to hold more liquidity and cash reserves, which support their balance sheet, thus increasing the demand for liquidity in the market. Further regulatory changes in this direction are being considered following the March 2023 banking stresses.

The US official sector is also changing the structure of the Treasury market to make it more resilient following episodes of dysfunction including the flash trading event in 2014, the repo spike in 2019 and dysfunction at the onset of the pandemic in 2020. The discussion focused on the Securities and Exchange Commission's mandate for central clearing of Treasury market transactions in particular. A panellist highlighted this would be a 'net positive by helping to reduce counterparty risk', but could increase the demand for liquidity through margin requirements and liquidity commitments for central clearing.

Implication for Reserve Managers

Despite the changes underway in Treasury markets, the consensus was this will not dissuade central bank reserve managers from holding dollars. One panellist remarked ‘the essence of central banks FX reserves is US Treasury liquidity’, given that the primary purpose of holding reserves is to ensure liquidity for the purposes of intervention. Sufficient liquidity is currently only available to central banks in US Treasuries.

The lack of alternatives to the dollar in foreign exchange reserves was also discussed. One audience member, from an emerging market central bank, mentioned there is ‘just no alternative to the dollar and US Treasuries’ given that it remains the most deep and liquid sovereign bond market. Despite the news of Brics forming an alternative currency, there was little confidence that this would either materialise or rival the dollar.

That said, one panellist acknowledged a ‘long-term trend towards diversifying FX reserves away from dollars’ to other currencies and asset classes. This is partly because many central banks now have ample FX reserves for intervention purposes and have a dedicated tranche for generating higher returns in other assets.

Gold is one asset highlighted by the panel as having gained from diversification. It has benefitted too from the current macroeconomic and geopolitical uncertainties, including the increased use of financial sanctions and higher inflation. It was noted that growing US Treasury issuance could impact liquidity in the Treasury market and returns and could encourage greater demand for alternative assets like gold. One speaker suggested ‘the market will not accept dollars under all circumstances’ but acknowledged the tipping point would be unclear. Others noted the limitations of using alternative assets like gold given the relatively limited liquidity they have.

Overall, the general message was that central banks will continue to rely on a well-functioning US Treasury market to support their reserve management strategies for the foreseeable future provided it continues to be a deep and liquid market. As a result, as mentioned in the BNY paper, ‘it is more important than ever that the Treasury market remains safe and liquid, with the private and public sectors working together to find ways to improve liquidity in particular, given the seismic shifts underway’.