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The Volcker Rule and Market Liquidity

The Volcker Rule will restrict banks' ability to speculate in financial markets. Recently, critics of the rule have claimed that it will lead to declines in market liquidity that will have serious economic effects. A new industry-funded study from Oliver Wyman claims that due to reduction in market liquidity the Volcker Rule could cost investors hundreds of billions of dollars in losses.

These claims are based on exaggerations in two areas. First, critics exaggerate any effect the Volcker Rule might have on market liquidity. Second, the economic impact of liquidity reduction cited in the Oliver Wyman study is enormously inflated. The dollar figures cited in the study are based on academic work that also includes the economic impacts of the financial crisis – which are far greater than the effects of liquidity changes in normal times. Combined, these errors lead to a complete misrepresentation of any economic effect the Volcker Rule might have.

The Volcker Rule Will Not Affect Liquidity To The Degree Claimed

New non-bank purchasers will replace liquidity lost when big bank speculation is reduced: Opponents of the Volcker Rule claim that restricting the ability of big banks to speculate in securities markets will remove an important set of customers from those markets. The decline in demand will lead to a decline in securities prices and an increase in costs for securities issuers. However, declines in securities prices below the level justified by real economic factors will draw new purchasers into these markets, such as hedge funds and other non-banks. That will restore liquidity. It is important to remember that the Volcker Rule places no limits on financial speculation and securities purchases by smaller non-banks like hedge funds – it only restricts speculation by large, systemically significant financial institutions.

The Volcker Rule continues to permit market making and underwriting: Market making – being a buyer or seller of last resort in financial markets – is the most important liquidity-supporting role played by large banks. The Volcker Rule continues to permit market making. The Volcker Rule will also permits banks to underwrite and help to sell new issues of securities by companies and governments seeking to raise new capital, another key source of market liquidity. Claims that the Volcker Rule is overly restrictive are in fact claims that banks should be allowed to continue to hold large-scale speculative inventories in excess of customer demand.

Oliver Wyman and Others Greatly Exaggerate Economic Impacts Of Liquidity Shortfalls

The Oliver Wyman study massively exaggerates economic costs by measuring them at the peak of the financial crisis: The study takes estimates of the dollar costs of reductions in

liquidity from an academic paper (Dick-Nielson et. al. 2011) that measures the liquidity costs created by the financial crisis. The Oliver Wyman study uses these estimates of price impacts, drawn from the peak of the worst financial crisis since the Great Depression, to determine the dollar impact of assumed changes in liquidity due to the Volcker Rule.[1] All significant dollar impacts in the study are determined this way. This amounts to taking the costs of the financial crisis and applying them to the Volcker Rule, a totally unjustified assumption.

Liquidity is a moving target, and shows no clear relationship with real economy growth: Liquidity and liquidity costs vary enormously over time and over the economic cycle. Studies have found that measures of market liquidity have varied by more than 100-fold over the course of the 20th century and are highly responsive to the economic cycle (Jones, 2002). Liquidity costs vary as well. At a time of market confidence the only cost of holding a less liquid security might be the need to make a few additional phone calls in order to sell the security. During a market panic less liquid securities might not be saleable at any price. Furthermore, high financial market liquidity, while it may be associated with somewhat higher securities prices, does not seem to be associated with growth in the real economy. A recent study demonstrates that growth in financial sector activities and liquidity provision has not been associated with more real economy investment or growth (Phillipon, 2011). For many decades, Glass-Steagall rules walled off large amounts of depository capital from financial markets with no apparent economic ill effects at all.

There is no one 'correct' level of liquidity: There is no single economically correct level of liquidity. Liquidity levels can be too high (and related costs too low). This occurs when buyers do not pay sufficient attention to the risks of their purchases and buy too quickly and easily. Overly high liquidity is associated with a market bubble, and leads to a market crash where liquidity suddenly disappears and liquidity costs soar. Well designed prudential rules that limit risk can prevent liquidity from becoming excessive and creating a bubble.

References

Dick-Nielsen, Jens, Feldhütter, Peter and Lando, David, "Corporate Bond Liquidity Before and After the Onset of the Subprime Crisis (May 31, 2011)". Journal of Financial Economics (JFE), Forthcoming. Available at SSRN: http://ssrn.com/abstract=1364635

Jones, Charles M., A Century of Stock Market Liquidity and Trading Costs (May 23, 2002). Available at SSRN: http://ssrn.com/abstract=313681

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[1] The academic paper measures declines in securities prices associated with lack of liquidity during the pre-crisis period of Q3 2005-Q2 2007, and compares them to price declines during the financial crisis period of Q3 2007-Q2 2009. For investment-grade bonds, price declines associated with low liquidity were over ten times higher during the financial crisis period (see p. 15 of the paper). The Oliver Wyman paper takes price declines from the 2007-2009 financial crisis period and applies them as a multiplier to determine economic effects of the Volcker Rule.