Opening Remarks

Ron Parker

I would like to welcome you to the Bank, and I encourage you to participate in the discussions that will take place over the next two days. I hope that we can build some real connections across the different types of participants represented here—academics, market participants, and policy-makers, because we are confronted with rapidly changing markets and difficult policy questions that require a real blending of the expertise that you all bring to the table.

My remarks will focus on two things: first, why is the Bank of Canada, and perhaps central banks in general, interested in market microstructures; and second, what policy issues have been the focal point of our attention thus far?

At the broadest level, the Bank of Canada is interested in the microstructure of markets because they play an important role in the efficient allocation of capital. Well-functioning markets, often described as liquid markets, are one of the core features of a well-functioning economy. The efficient transfer of information through markets is an enormously important public good.

Markets are playing an increasingly significant role in the capital-allocation process in many industrialized economies. While banks and other financial intermediaries are still very important sources of funds, the proportion of funds raised through equity and debt markets has risen considerably. Indeed, it is not uncommon to hear the argument that the development of markets has led to increased financial stability—when one source of funds is not functioning well, the other channel may be available.

How well markets function is also crucial for at least three reasons, all of which touch upon efficiency in some way.

First, how well markets function can have a significant effect on the willingness of domestic and foreign investors to participate in markets, which is why the quality of regulation and codes of ethics guiding participant behaviour is so important.

Second, well-functioning markets have a direct bearing on the implementation of monetary policy, because it depends on the efficient transmission of information from the policy interest rate to other financial asset prices.

And third, the efficiency of market structures during times of stress is of considerable importance from a financial stability perspective—does the transmission of shocks across markets affect the stability of the financial system as a whole?

Consequently, central banks have an interest in how well markets function. One might ask, however, what contribution central banks can bring to the policy debates around market structures.

I think one of the unique contributions of central banks is a focus on the economic incentives underlying a particular set of market structures. Incentive structures and moral hazard are major issues for central bankers. These are things that we think about a lot. Central banks also approach issues from a broader macroeconomic or system-wide perspective rather than from a sectorial or regulatory one. Perhaps most importantly, they bring a mix of practical experience and applied research that can provide useful insights for understanding particular markets, especially fixed-income and foreign exchange markets.

I would like to move on to discuss the second question: the policy issues that have been a focal point for our microstructure research.

Several years ago, the Financial Markets Department started looking seriously at microstructure issues as part of our research program when it became clear that the number of developments affecting how markets are organized and how well they might function was accumulating. We needed to be able to better understand how some of these shocks might affect markets in Canada.

The following shocks seemed relevant.

- First, changes in technology are having very large effects on markets, but perhaps one of the most significant consequences of the rapid decline in computing and telecommunications costs is its effect on how markets are organized: being part of the network through which information is flowing or part of the network delivering a particular set of services to clients is becoming much more important. But whether these changes in technology have affected the monetary policy transmission mechanism and where markets will be located are of particular interest to us.

- The introduction of the euro and the harmonization of the legal and regulatory framework in Europe.
- Changes in the regulatory environment, such as new and evolving capital standards and new ways of managing financial risks.
- Consolidation across both financial intermediaries and investors is another trend we are observing. While this is almost certainly not independent of other changes such as the economies of scale technology now makes possible or more efficient risk-pooling (also brought about by technology), from a policy perspective, it gives rise to a number of competition and market-structure issues.

One focus of our work has been on the market-structure implications of electronic trading systems in debt markets. This research is reflected in a number of the Bank papers prepared for this conference. Two themes have emerged from this work.

First, common transparency standards across all types of debt markets could be counterproductive, especially in wholesale debt markets. There are, for example, important differences between order-driven and quote-driven market structures. The appropriate level of transparency can also be a function of the stage of development of markets—how easily information is absorbed and risk is transferred, for instance. Transparency rules should also consider differences in trade types: retail-type trades, non-market-moving trades, and non-information-carrying trades are very different from wholesale-market trades that may have considerable information content.

The second theme has been that increased transparency in markets may not necessarily result in more optimal outcomes. In government or other bond markets, greater transparency may harm liquidity, since it could affect the ability of dealers to manage their inventory risk and therefore result in less efficient overall allocation of risks in the market.

These observations have led us to the conclusion that from a policy perspective, one should avoid a “one size fits all” approach when assessing the need for market rules.

Our work has underscored the fact that market microstructure changes give rise to numerous trade-offs with gainers and losers, so it is not possible to describe “optimal” trading arrangements, as observed by Helen Allen of the Bank of England and her BIS co-authors (Bank for International Settlements 2001). These challenges seem even larger in a marketplace like Canada’s that is dominated by a relatively small number of large dealers and a relatively small number of large investors. Determining what changes will do no harm, as Mr. Greenspan advises, is what our research program is about and I know that this conference and the discussions over the next two days will make an important contribution to the policy decisions that lie ahead.

Reference

Bank for International Settlements. 2001. "The Changing Shape of Fixed Income Markets." Working Paper No. 104. Study Group on Fixed Income Markets.