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OPINION

Fixing the Fed's Liquidity Mess

By Lawrence Goodman And Stephen Dizard

Every Treasury secretary since the late 1930s could proclaim with confidence that the U.S. bond market is the deepest and most liquid in the world. Today's illiquid debt markets threaten the potency of this pledge and put the global economy at risk for another financial crisis.

Fortunately, risks to financial stability radiating from bond markets have captured the attention of the U.S. government. This isn't surprising given the Treasury "flash crash" of Oct. 15, 2014, when a shortage of liquidity hastened a 37 basis-point slide in yields in a mere two hours. Statistically, this equates to a change expected once in over 500 million days.

Quantitative easing and a near-zero interest rate have produced lopsided positions that risk another crisis.

A new U.S. government staff report on the "significant and unexplained volatility" in the U.S. Treasury market identified several technical issues of possible concern. Yet the report missed key challenges. It was also light on acknowledging unintended consequences from policy decisions and offering plausible solutions.

The likelihood of more violent fluctuations is high. Michael Lewis stunned many by alleging in his most recent book, "Flash Boys," that the equity market is "rigged." Actually, the sovereign-debt market has been rigged and manipulated since the Federal Reserve's second quantitative-easing program began in 2010, throwing all bond markets off-kilter.

In March 2012 we wrote in these pages how the Fed was manipulating the U.S. Treasury market through QE by buying an unprecedented 61% of all Treasury issuance. Fed purchases peaked at close to 80% last year.

These central-bank interventions force the bellwether interest rate below its natural level. Investors progressively chase higher-yielding alternatives. Skewed exposures to riskier debt such as corporate bonds mount over time. Similarly, a scarcity of high-quality Treasury debt leads investors to buy bonds, pushing yields lower, and resulting in a series of one-way bets.

Many of us with experience in emerging markets are acutely sensitive to the risk of lopsided positions built over time. When this happens, a minor disturbance often unleashes a sharp cascade in prices and the evaporation of liquidity. In the U.S. today, QE has resulted in investors piling into bonds at high prices. If investors rush to reduce these supersize positions, they will encounter a market less capable of handling large transactions. This will likely result in a sharp drop in prices, possibly prompting another crisis.

A seizure in the market for Treasurys would have a debilitating impact well beyond fat-cat financial institutions. The buying and selling of U.S. Treasurys is the backbone for small- and medium-size financial institutions, corporations and credit to individuals.

The Fed should work constructively with private businesses to restore depth and liquidity in major bond markets. And because it will take time to implement solutions, the Fed and other financial regulators should act immediately to do the following:

• Lift the federal-funds rate to neutral levels. The Fed must exit its postcrisis near-zero interest rate policy smoothly and resolutely. The longer it waits the deeper imbalances grow domestically and internationally, as central banks around the world are forced to keep their interest rates well below natural levels.

• Ease restrictions on market finance. Since the 2010 Dodd-Frank law, there has been a collapse in available market liquidity despite more than ample central-bank liquidity. Our data show that the availability of market finance—repurchase agreements, commercial paper and money-market funds—is nearly 30% below a reasonable level to support liquid markets and economic growth.

U.S. financial regulators would be well advised to ease restrictions that raise the costs to financial institutions of operating in plain-vanilla markets such as repurchase agreements. This coupled with a normalized federal-funds rate would help restore a market essential for fueling liquidity and credit to institutions of all sizes.

• Arrange new private-sector liquidity facilities. History illustrates how precise infusions of funding can restore health to illiquid markets during times of distress. Today, new challenges require fresh ideas—such as private-sector liquidity facilities. As a first line of defense, bankers need to work with debt issuers to design, authorize and pre-fund liability management facilities tailored for expected crisis conditions.

Leading investment firms should raise funding now. The Fed's stress-test definition of a "severely adverse" scenario could provide the contingency triggers for deploying that funding: a 30% decline in equity indexes and a 500 basis-point widening of corporate-bond spreads. In a crisis, the Fed, acting as a coordinator, could call the firepower and expertise to the table to organize support for broken markets.

There is substantial private and public capital available to pre-fund liquidity buffers. Cash on corporate balance sheets abounds. The top 100 publicly traded companies in the U.S. hold more than $3.2 trillion in cash and marketable securities. Sovereign-wealth funds, pension funds, insurance companies, private-equity firms and hedge funds also have substantial cash on hand. But the availability of this liquidity does not mean it will be deployed when needed.

Private-sector buffers—developed in concert with the Fed and Treasury—would strengthen the existing legal and market structures and bypass the need for new emergency governmental powers to force capital into markets.

Severe liquidity risks will not heal themselves. To lessen the likelihood of another widespread financial crisis, the time to act is now.

Mr. Goodman is president of the Center for Financial Stability, where Mr. Dizard serves as special counselor.