The Global Liquidity Paradox

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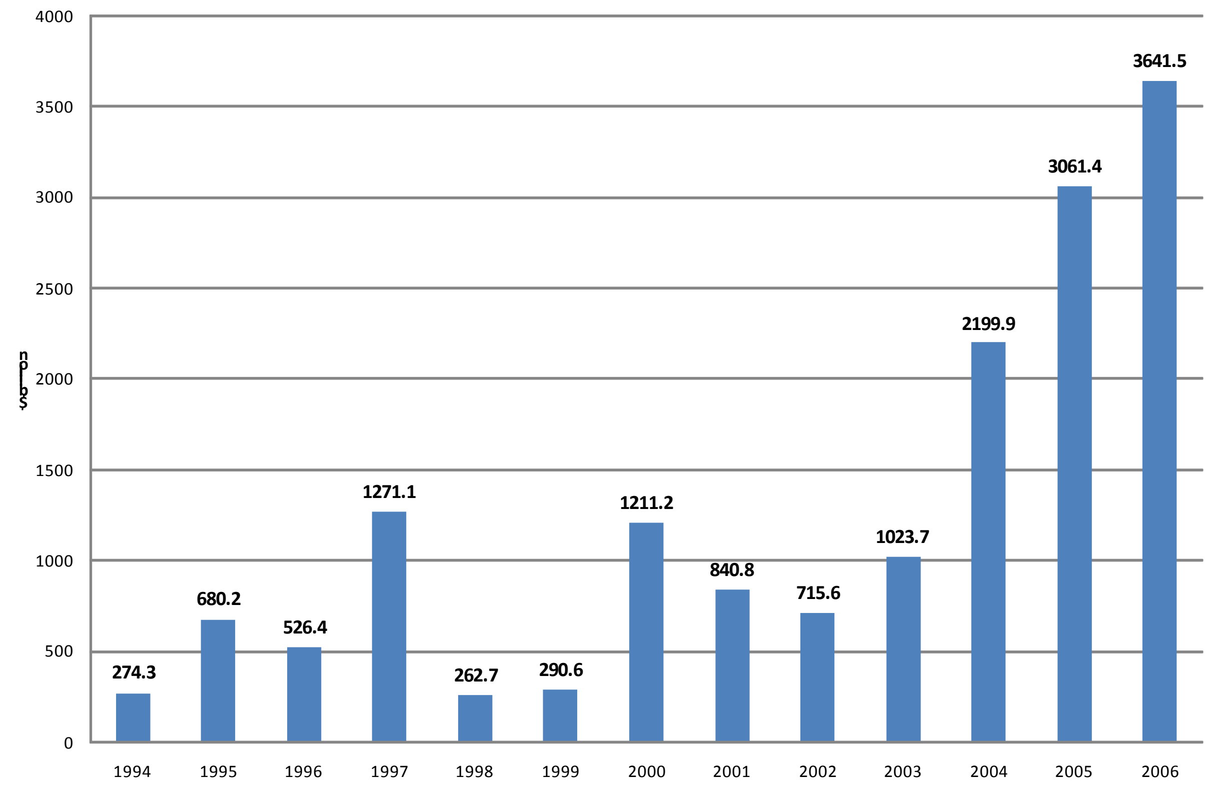
A much-discussed fall out of the US sub-prime crisis is a global liquidity squeeze. Assets are liquid when those who hold them can sell them in the market at a price that does not imply a huge loss, so as to access the cash they need to meet other commitments. When market prices rule low, implying losses for asset holders that can threaten their survival, the market or segments of it is seen to e experiencing a liquidity squeeze. When there are no buyers in the market either because investors consider most financial assets worthless or are unsure about their value, the system faces a liquidity crisis. Operating on the principle that this is the problem that afflicts global markets, central banks in the US, UK and Europe are reducing interest rates (to raise the value of financial assets) and pumping liquidity into the system (to enhance demand for financial assets), hoping to resolve the problem before the onset of a full-fledged recession.

This short term response is understandable. While it unjustly rewards financial investors who were inadequately diligent, made speculative investments and attempted to conceal and pass on the risk to others, it may be the only option that central bankers have. What is paradoxical, however, is that the problem of inadequate liquidity that precipitated this response was in the first instance the result of a process that led to a sharp build up in the level of liquidity in the international system. The problem therefore seems to be one of excessive increases in global liquidity, with the more recent liquidity squeeze being a symptom of the crisis precipitated by excess liquidity.

Given its definition, measuring liquidity is near impossible. But, as is well recognized, a market is more liquid when there are more investors active in that market. So the volume of transactions occurring in markets is an indicator of the extent of liquidity in the system. Despite the diversified and complex nature of financial markets today, the banking sector sits at the centre of the financial system, mobilizing and allocating much of the capital that goes to determine the overall state of liquidity. Based on that perception, researchers have used changes in the external or international exposure of banks in different reporting countries as an indicator of trends in global liquidity. Since the debt crisis, the Bank of International Settlements has encouraged banks located in different countries to report their international exposure through an official system, with institutions from 40 countries reporting currently. The number of reporting countries has increased over time making the absolute figures incomparable. However, continuous figures are available from 1994 for 23 reporting countries.

When we examine those figures it becomes clear that there has been a sharp increase in global liquidity (as proxied by international exposure of banks) in the period after 2002 (Chart 1). Having touched a low of $716 billion that year, the exchange rate-adjusted changes in the external asset positions of banks in these countries registered a more than five-fold nominal increase to touch \$3.6 trillion in 2006. This compares with a previous peak of \$1.3 trillion touched in 1997 at the time of the Southeast Asian financial crisis. It hardly bears stating that when global liquidity is increasing at this rate, liquidity in the countries in which these banks are located would be rising as well. They are not merely recipients of flows from banks located elsewhere, but the domestic exposure of banks normally tends to rise along with their international exposure, even though the rise in levels of cross-border inter-bank flows results in a rise in the ratio of such flows relative to the corresponding measure of domestic liquidity.

Chart 1: Exchange Rate Adjusted Changes of External Positions of Banks in 23 Countries



Experience from previous crises, especially the Southeast Asian crisis of 1997, suggests that a rapid expansion of international liquidity results in an increase in the proportion of speculative positions taken by market participants and a decline in credit quality. In particular, increased cross-border flows can be accompanied by complex carry trades, with money flowing from locations, markets and instruments where returns are low to targets offering high returns. This can lead to speculative bubbles in one or more locations. In addition, cross-border flows increase the potential for “contagion”—the international transmission of the effects of financial instability.

For example, apropos 1997, a Bank of Italy study found that: “In the period between 1995 and

1997, global interbank activity expanded rapidly, characterized … by net outflows from Japan. During this period, the banking system of the industrial countries (excluding Japan) played the role of intermediary in the reallocation of flows, having made loans to offshore centres that were nearly equal to fund-raising from Japan ($50 billion). The flows to emerging economies were enormous: $150 billion to banks and $130 billion to non-bank agents. Large capital flows (around $100 billion) were recorded in favour of non-bank agents located in offshore centres, among which some non-bank financial intermediaries such as hedge funds are also probably included."

There is reason to believe that similar developments were occurring in the course of the more recent liquidity surge. Between June 2003 and June 2007, total foreign claims of banks in all reporting countries increased by 112 per cent with respect to developed countries, 102 per cent with respect to offshore centres and 163 per cent with respect to developing countries (Table 1). There is a high degree of concentration of flows to developing countries in Europe and the Asia-Pacific. Flows to offshore centres and developing countries from different developed country locations increased by between 100 and 240 per cent over this four year period. This implies that though instability has currently affected the market for mortgage loans and mortgage-backed securities, the problems created by an excessive expansion of liquidity affects all favoured investment locations including developing countries in Europe and the Asia-Pacific.

Table 1: Percentage increase in exposure to different locations by nationality of banks, 2003-2007

Claims vis-à-vis	**Total foreign claims**	**Japan**	**U.K.**	**U.S.**	**Other**
All countries	115.5	65.9	122.1	118.1	119.8
Developed countries	112.0	54.8	122.0	116.0	116.4
Offshore centres	102.2	105.4	69.8	150.0	110.1
Developing countries	163.2	118.7	240.5	114.0	165.1
Africa & Middle East	154.6	88.5	399.7	164.0	98.1
Asia & Pacific	181.2	111.2	244.2	204.4	169.6
Europe	267.9	392.4	251.3	192.8	271.9
Latin America/Caribbean	74.0	74.9	108.6	39.1	82.3
Int. organisations	-13.7	...	-71.7	...	42.3
Unallocated	-61.0	...	-70.1	...	-60.9

Not surprisingly, in the recent surge in capital flows to developing countries, almost all emerging markets, especially those in Europe and the Asia-Pacific have witnessed an increase in inflows, with attendant buoyancy in their stock and real estate markets. These inflows have implied the accumulation of speculative positions by many investors, including highly leveraged ones. One possible indicator of that tendency is while the outstanding values of all kinds of international assets held by banks have doubled during the recent surge (2003-2007), derivative contracts, especially over the counter derivative contracts have increased by much more (Table 2).

What this suggests is that the problems arising from the sub-prime loan crisis and the collateralized debt obligations associated with sub-prime loans reflects the unraveling of one set of problems created by the liquidity spiral of recent years. The other, which could have and cal still unravel is the excessive exposure, encouraged by excess liquidity, of international investors and lenders in a few developing countries and the securitized assets that have been built on that exposure. That is a supply-side push of capital into the stock, credit and real estate markets in emerging markets could have created a second source of fragility in the international financial system besides the US sub-prime market.

Table 2: Changes in Outstanding Positions for Key International Financial Assets ($ billion)

	Jun-07	Jun-03
Total external asset positions of banks	29980.5	14853.8
Claims on banks	19094.6	9663.6
Claims on non banks	10886	5190.2
External Loans	21920	11130.7
International debt securities	20878.3	10268.7
International money market instruments	1114.3	519.3
International bonds and notes	19764	9749.5
OTC derivatives (notional value)	513407	169678
Exchange-traded derivatives		
Futures	31676.9	13930.5
Options	65006.7	24286.6

This is of significance because the lesson from the sub-prime loan crisis is that when suspect loans result in default of payments, those loan assets and the securitized obligations that have been built on them become suspect as well, resulting in a drying up of demand for such assets. Holders of such assets who want to sell, even if at a loss, to meet commitments that fall due, find there are no takers, so that a financial world that was till recently awash with liquidity suddenly turns illiquid. This has happened with only one segment of the market experiencing a doubtful loan or investment problem. If the build-up of speculative positions in other markets that was also associated with the recent surge in liquidity generates new problem loans and investments, the transformation from liquidity excess to liquidity squeeze may be far too severe for central bankers and government to resolve without much damage.

What needs investigating, therefore, is the set of factors that led to the liquidity build up in the first place. One factor is of course a sudden accumulation of foreign exchange surpluses with a few countries and firms, resulting from an increase in, oil prices for example. With these oil surpluses looking for investment opportunities finding their way to financial markets, an excess liquidity syndrome may result. In fact, there is a close association between the movements of oil prices and the build of global liquidity in recent years.

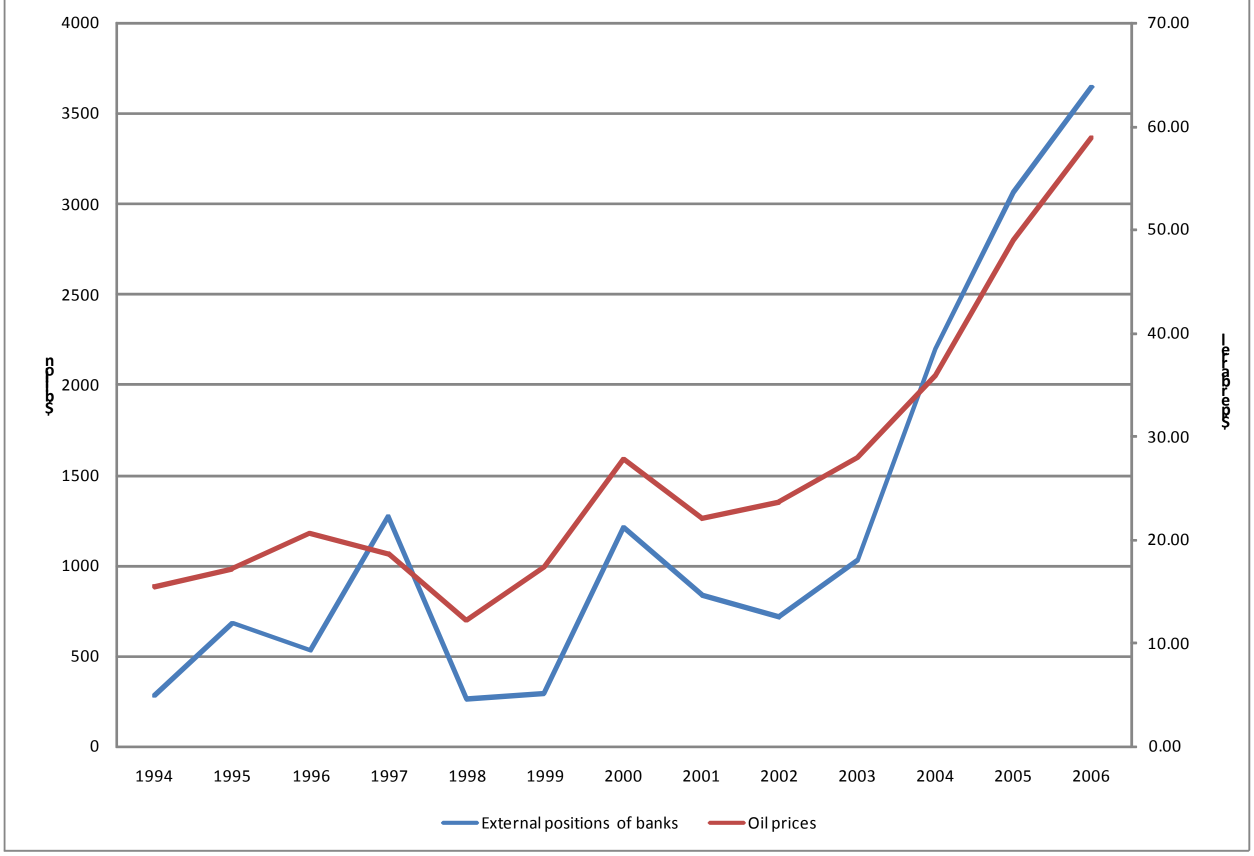


Chart 2: Global Liquidity and Oil Prices

But this is only one fortuitous development contributing to liquidity. Moreover, since speculation touches commodities as well, the direction of causation also moves from liquidity to oil prices, as it does the other way around. There are three other factors that have possibly played a role. The first is the long term tendency in the contemporary global system for an increase in liquidity. Contemporary globalization breeds inequality and feeds on it. Global and national inequalities concentrate incomes among a few, whether they be the millionaires in the developed and developing world who accumulate savings looking for avenues of investment or sections of the middle class that accumulate financial capital through investments in mutual and pension funds, that need to be invested to meet future commitments. Neo-liberal reform by reducing State provisions for social security only aggravates this process, since it requires the middle class to save for contingencies or old age. The financial component of neo-liberal reform permits pension funds and insurance companies to invest this capital in a wider range of assets, resulting in the expansion of a range of new asset classes like private equity.

A second reason for the liquidity build-up noted by many observers is a tendency in recent years for developed country central banks to adopt an easy money policy aimed at encouraging credit-financed spending in housing and consumer goods markets that keeps demand buoyant and GDP growth at "acceptable" levels.

Finally a third reason could be that developing countries that were adversely affected by or threatened by the financial crises of 1997 and thereafter had turned more cautious about being profligate with foreign exchange. This in most cases has involved maintaining investment rates below domestic savings rates to generate current account surpluses, or, where current account deficits existed, making sure that not all capital inflows in a more liberalized environment were spent on current or capital expenditures. The net result has been a huge build up in foreign exchange surpluses in developing countries which in myriad ways finds their way to financial centres in the developed countries, only to partly return as investments in emerging markets. That is, the crisis generated by excess liquidity in the past results in an environment that contributes to a new round of liquidity accumulation.

Given these in-built mechanisms in the system that result in an increase in global liquidity, that are aggravated by developments such as an oil price increase, governments must find ways to rein in liquidity increases. Because when excess liquidity builds up globally speculative positions are an inevitable outcome with attendant consequences of the kind represented by the 1997 crisis and the more recent sub-prime experience.