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PERSPECTIVES

International Liquidity

Stephen Grenville

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As financial markets have become more integrated and international capital flows larger, overseas conditions – growth, inflation, terms of trade, spare productive capacity, inflation – all impinge more strongly on the domestic economy. At the same time, the transmission channels of policy have certainly changed, so the policy instruments need to be recalibrated.

In coming to understand this and incorporate the impact of globalisation into the policy process and into financial market assessments, policy-makers and economic commentators alike are searching for indices which compress the complexity of these influences into a few simple measures which will have some predictive power in forecasting the path of the world economy. We argue here that one of the frequently-used measures – international liquidity – has too many different meanings to be useful. Analogies with concepts of domestic liquidity are misleading in the international context. The best measure of the stance of monetary policy will be the level of interest rates rather than any of the measures of liquidity.

The diverse meanings of liquidity

Within the domestic economic context, liquidity has a variety of meanings:

- Market liquidity: the ease with which an asset can be sold, particularly whether this can be done in large volume without depressing the price.
- Institutional liquidity: an institution is liquid if its balance sheet has a high proportion of assets whose value can be quickly realised to meet debts.
- Monetary liquidity: originally liquidity referred to base money – the building block and policy instrument of the credit multiplier process. More loosely, it had come to be used as a general reflection of the stance of policy and monetary conditions. In this loose meaning, it can either be a *price* – an interest rate, or a *quantity* – one of the monetary aggregates or credit.

The common thread running through these different concepts of liquidity is the idea of *readily available spending power*. When these diverse ideas are applied in the international context, however, they are vague and heuristic, but nevertheless many commentators see this as a leading indicator of where the world economy is heading.

Recent financial commentary has referred to a 'global gusher' of liquidity.[1] Another commentator says: 'Low-yielding currencies have been used as a world cash machine, pushing liquidity into asset markets'.[2] Semantic imprecision leads to analytical confusion. There are far too many different concepts wrapped up in this broad idea to make it a helpful analytical or predictive tool. To give it analytical meaning, we need a clearer idea of how liquidity relates to, and can shed light on, the future development of the international economy.

Measuring international liquidity

While much of the commentary is in terms of arm-waving generalities ('gushers' and 'cash machines'), some commentators have offered specific time series, usually multi-country aggregations of one of the measures of money (including credit), or foreign exchange reserves. Both the International Monetary Fund and the respected economic journal The Economist use a version which aggregates US base money and foreign reserves held at the US Federal Reserve – what The Economist refers to as 'the global supply of dollars'.

There are two historical antecedents which may go some way to explain this choice. One is a residual memory of the international 'dollar shortage' after WWII. The second is the old idea of 'too much money chasing too few goods'. Milton Friedman was the populariser of this idea, but it goes back much further, to the days of the gold standard, when it might have had some analytical relevance. Behind these notions of liquidity may be some half-remembered hangover from an introductory economics lecture, with the notion that people (and countries) might somehow find themselves with 'too much money', and would spend it, bidding up prices. But if we look at the two components of the IMF and The Economist measure, they don't make much sense.

The component of US base money is largely the dollar bills in American wallets and purses: the impact of changes in these holdings on world demand will be so indirect as to be

[1] The Economist , 4 January 2007.
[2] Financial Times, 14 February 2007.

minuscule. For the US citizens holding a component of this notion of international liquidity (and for holders of currency everywhere) we can quickly dismiss the idea that excess liquidity might mean that people have too much currency in their wallets and purses, and that they will react by spending. The public always holds just the amount of currency it wants to hold for transactions and so on: if, for some reason, someone received an unexpected bundle of banknotes (Milton Friedman's famous hypothetical helicopter-drop of currency?), they don't have to spend them – they can deposit them at the bank. So the idea of excessive currency burning a hole on your pocket doesn't make much sense, either domestically or internationally.

We can equally swiftly dismiss the idea that when the public unloads its excess currency holdings on to the banks, the banks will get rid of their excess liquidity by making loans which will boost demand. Why would the banks do this? Banks operating in a deregulated system (i.e. the real world for the past two decades or more) are already making all the loans that they consider to be bankable at the current interest rate, so providing them with more liquidity makes no difference to their lending. This has been demonstrated in the past five years or so: the Bank of Japan's policy of 'Quantitative Easing' increased banks' reserve holdings tenfold without any discernable impact on their lending. Unless the central bank changes its operational target by lowering the official short-term interest rate, simply having more reserves does not cause the banks to expand credit.

What about the other component of this concept of international liquidity – international reserves? It is equally unhelpful for analytical clarity to refer to the collective foreign exchange holdings of central banks (either the dollar component or the total) as international liquidity, as if it is waiting to be splurged on boosting world demand. Who will do the splurging and why? Governments and central banks are holding these reserves voluntarily, and, just like individual people's currency holding, there is no reason to think that the holders will suddenly judge their holdings to be excessive and bid up world output and prices in an attempt to get rid of their surplus funds. To the extent that the large increase in holdings by China, Japan and the oil exporters reflects the existing international current account imbalances, then its not at all clear that this is a predictor of coming excess demand: on the contrary, it seems more likely (although not inevitable) that the adjustment to these imbalances, when it comes, will involve some slowing in the US, with this being passed on to the rest of the world. Perhaps the proponents of this measure of international liquidity have transposed the idea of *institutional* liquidity so that it applies to countries? In this case, high levels of foreign exchange reserves might make particular countries less susceptible to

international shocks. But if so we need to know, country-by-country, whether there is capacity to absorb shocks: the world aggregate is no use.

If interest rates are low and the risk appetite of lenders has increased, credit might seem easy to obtain, so liquidity is sometimes used as a synonym for credit. As a general idea, this makes some sense, both domestically and internationally: if there is an expansion of bank balance sheets, this will often be associated with an expansion of economic activity, so credit or broad measures of money might be a sign of expansion in economic activity. Credit is rarely a *leading* indicator, however, because by the time the extra credit appears in the statistics, it has already been spent and is no longer a source of potential future expenditure: it's just a debt which the borrower has to repay. For most countries, financial deregulation destroyed the predictability of the relationship between these money measures and domestic economic activity. More recently, derivatives have further complicated the picture, domestically and internationally, as they provide the opportunity for leverage without this being recorded on balance sheets or in the credit aggregates. It was for this very reason that monetary aggregates lost their potency as a measure of the stance of policy: other funding substitutes came along outside the definition. As the Governor of the Bank of Canada during the 1970s said: 'We didn't abandon monetary aggregates; they abandoned us.' Leaving these complications aside, analysing credit growth might be useful, *within an individual country*, relating this to the current stance of policy-determined interest rates and the degree of spare capacity in the economy. The European Central Bank maintains a focus on monetary aggregates (its 'second pillar' of policy). But adding this up for the world doesn't offer much in the way of insights, and in any case this discussion will be clearer if it avoids confusing credit with liquidity.

Why monetary conditions should be measured in terms of interest rates

At the domestic level, the breakdown of stable relationships between money and activity produced the switch in policy focus from *quantity* to *price*. The same switch is appropriate at the international level. If we need to assess the stance of monetary policy around the world, the focus should be on the level of interest rates. These are, almost universally, the instrument that central banks use to set their policy stance. Of course they need to be put in context: where credit risk premia have been dramatically bid down, this has to be factored in when assessing the impact on demand (and in assessing the risks that this lending will go wrong). The shape of the yield curve will also be relevant. These are, however, just different aspects

or facets of the *price* of funding – the interest rate. If credit is growing too fast, the only way monetary policy can affect this is to raise interest rates.

The story of the international repercussions of monetary policy can be told clearly enough without resorting to any concept of excess liquidity or liquidity overhang. As a result of the 'lost decade' in Japan and 'cleaning up the mess' (former Fed Vice Chairman Alan Blinder's term) after the Tech Wreck, interest rates in two principal world players – the USA and Japan – were historically very low for much of the last decade (particularly 2002–2005). This not only had impact in these countries' domestic economies, but also affected international capital flows. The 'yen carry trade' and low-interest dollar loans took cheap funding into global markets. This, not some nebulous concept of liquidity, should be the starting point for analysis and understanding this period.

Narrowing the definition of liquidity

One small step in sorting out this semantic and analytical mess would be to use the word liquidity more parsimoniously. The common thread running through the variety of ideas is that liquidity embodies the notion of *readily available spending power*. But, in a world where sophisticated financial markets have created liquidity for most assets (in the sense of the ability to sell them readily) where none existed before, we need to narrow the usage. Liquid assets are certainly much wider than money balances.

Why not confine liquidity to the first two concepts mentioned above?

- Institutional liquidity: the continued ability of individual financial institutions to meet claims as they fall due: and

- Market liquidity: the depth of markets for the sale or loan of assets or the hedging of the risks that underlie those assets.

For the prudential supervisors of the financial sector, for a bank manager and for a finance officer, liquidity in a balance sheet is a desirable quality which demonstrates an ability to absorb shocks. Related to this, investors will favourably regard assets which have the characteristic of being liquid: able to be sold quickly and in large volume without requiring

the price to be discounted. Liquidity will still have some role in domestic monetary policy discussion, as a characteristic of specific markets.[3]

This would leave the international discussion uncluttered by the vague terminology of liquidity. This is not to argue that international financial flows are irrelevant for the development of the world economy: far from it. The glib measures of liquidity are a distraction from this more complex story.

Conclusion

As the world becomes more financially integrated, there will be more interest in trying to understand the implications of the huge flows of international finance, and the outstanding balances of international debt and assets, with their differing currency of denomination, that are part and parcel of globalisation. This imposes new constraints on domestic policy: foreign interest rates will be an important input into setting domestic rates. Monetary policy might work more through the exchange rate than interest rates, which means that shocks (the demand cycle, terms-of trade-changes and so on) will impinge unequally on the tradable and non-tradable sectors. It is easier for countries to sustain current account imbalances and accumulate large external debt. Residents have new options to borrow and lend, and for some this will mean new opportunities to gear up and increase demand, giving them 'more rope to hang themselves'. Asset prices will be set much more by international demand and supply, and this may be fickle and volatile. Countries may respond to international flows by altering interest rates or fiscal policies, or by allowing their foreign exchange reserves to fluctuate. If foreign reserves rise, central banks find it more difficult to keep close control over domestic bank reserve assets.

With each of us having a greater stake in the international connections, we will want to monitor them more closely. We might want to know how exposed we are to changes of international sentiment and how much room countries have to cope with unexpected shocks – how much liquidity their financial systems have, and how liquid their markets are. Let's talk about the stance of monetary policy in terms of the policy instrument – short term interest rates or the outcome – growth in credit. All these are important issues that need to be worked

[3] As US Fed Chairman Greenspan noted: 'Central banks… do not respond to gradually rising asset prices. We do respond to sharply reduced asset prices which create a seizing up of liquidity'. Quoted in IMF (1999) p 4.

through. There is no useful place in this discussion for confused notions of international liquidity.

> ‘When I use a word,’ Humpty Dumpty said in rather a scornful tone,
> ‘it means just what I choose it to mean – neither more or less.’
> ‘The question is,’ said Alice, ‘whether you can make words mean so many different things.’
> ‘The question is,’ said Humpty Dumpty, ‘which is to be master - that's all.’
>
> Lewis Carroll

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ABOUT THE AUTHOR

Dr Stephen Grenville is a Visiting Fellow at the Lowy Institute for International Policy and works as a consultant on financial sector issues in East Asia. He is a Director of AMP Capital Investors Limited and an Adjunct Professor at the Australian National University. Between 1982 and 2001 he worked at the Reserve Bank of Australia, for the last five years as Deputy Governor and Board member.

Before that, Dr Grenville was with the Organisation for Economic Co-operation and Development in Paris, the International Monetary Fund in Jakarta, the Australian National University and the Department of Foreign Affairs.

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