

## B. Historical Developments of Global Liquidity

There are some noteworthy differences in the extent the dynamics of core and noncore global liquidity aggregates can be explained by the demands (pull) or supply (push) factors (Figures 6 and 7).<sup>18</sup>

In the case of core liquidity (Figure 6), it is possible to distinguish between three periods: (i) the brief period between 1999 and 2001 when positive liquidity supply shocks were outweighed by negative demand shocks, slowly reducing the available quantity of liquidity (as a ratio of GDP); (ii) the period when negative liquidity supply shocks brought the quantity of core liquidity well below trend by 2008, as investors were seeking more profitable investment instruments (e.g., money market funds, riskier assets); and (iii) the period during the global financing crisis when the positive liquidity demand and supply shocks kept core global liquidity above trend.

In the case of noncore global liquidity, one can distinguish between four periods (Figure 7): (i) the first period when positive liquidity supply shocks allowed noncore liquidity (as a ratio to GDP) to trend upward, by remaining overall below trend; (ii) between 2005–07, when positive liquidity supply shocks contributed to rapid growth in noncore global liquidity, consistent with “inside” money creation, as global banks were able to create liquidity through a combination of leverage, financial innovation, and search for yield; (iii) during the global financial crisis, when the behavior of noncore liquidity was driven by a combination of falling supply, reflecting sudden retrenchment in wholesale markets, and rising demand, as banks needed funding to roll-over outstanding liabilities, the quantity of noncore liquidity remained stable, while its price increased sharply; and (iv) in 2011 onwards, when negative liquidity supply shocks depressed both the price and quantity of noncore liquidity, in line with the well-documented deleveraging in the shadow banking system.

It would be reasonable to conjecture that it was during the second period—between 2005 and 2007—that vulnerabilities started to build up, when financial innovation and other push factors allowed for an expansion of noncore liabilities, without a corresponding upward price pressure that could have served as a cooling mechanism (Figure 7). Poszar (2011), for example, argues that the increase in institutional cash pools (i.e., large centrally-managed short-term cash balances of global nonfinancial corporations and institutional investors) and their search for safe and liquid assets played an important role in the rise in the shadow banking system.<sup>19</sup>

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<sup>18</sup>Note that the sum of the cumulative contributions from demand and supply factors does not add up to the total quantity level, due to the persistent contributions of supply and demand shocks that have occurred prior to the start of the sample.

<sup>19</sup>Poszar (2011) argues that yield was only the third priority for this set of investors, liquidity and safety of the principal being the more important considerations.