

I. INTRODUCTION

Recent financial crises in the U.S. and Europe have brought the impact of liquidity on economic and financial stability into sharp relief. Much of this impact has long been documented. Domestically, liquidity has been seen as having important implications for the real economy and the financial system (for example Friedman and Schwarz, 1963). It can drive up asset prices and encourage risk-taking, with negative consequences for financial stability (Borio and Zhu, 2008). Globally, the allocation liquidity affects macroeconomic and financial developments in ways that are not directly under the control of national policymaker (a theme of recent GFSR and spillover reports, see IMF, 2011a; IMF, 2011b; IMF, 2011c; IMF, 2011d; also Matsumoto, 2011; and Darius and Radde, 2010).

At the most basic level, liquidity can be described as the amount of funding readily available to finance domestic and cross-border asset purchases. Liquidity reflects both the ability and willingness of parties to engage in financial transactions, including intermediation, as well as the capacity of financial markets to absorb temporary fluctuations in demand and supply without undue dislocations in prices. In part because of the many purposes liquidity serves, there is no straightforward way to assess developments in global liquidity conditions.¹

One challenge in measuring liquidity is that it is largely endogenous and highly cyclical, contributing to the build-up of risks to financial stability and be affected by them in return. While central bank injection of base money plays an important role in liquidity creation, flows in global liquidity are also driven by growth differentials, financial innovation, and market participants' risk appetite (CGFS, 2011). For example, the recent explosion of collateralized market-based borrowing, where funding expands or contracts depending on the market value of the underlying collateral, has introduced a significant source of endogeneity (IMF, 2011e, 2011f, 2011g). Similarly, if for some reason, private agents become unwilling to transact, much of the liquidity can disappear and the same amount of liquidity as measured by quantity aggregates may go from being abundant to scarce, with attendant price increases, while exacerbating the potentially volatile nature of liquidity.

The case for monitoring global liquidity conditions is not straightforward. While there is conflicting evidence whether national monetary aggregates contain useful information about the business cycles, and possible asset price misalignments², the value of aggregating national monetary aggregates is particularly questionable given their differences. Domestic quantity measures of money aggregates have fallen out of fashion in some countries, such as the United States, because of the lack of empirically-stable relations between money

¹This work is an expansion of preliminary work produced in the context of a G-20 work request to help deepen the understanding of the role of global liquidity in the international monetary system.

²See, for example, Gerdesmeier, D., Reimers, H.-E. and Roffia, B., 2010; Alessi, L. and Detken, C. 2011 and Box 2 in the ECB Annual Report (2011).