quantity, but a decline in price. It is the protracted periods of low prices seen in the latter scenario—a result of positive supply shocks—that can raise risks to financial and economic stability. Moreover, while quantities are sticky in a downward adjustment, changes in prices may be more telling in a crisis. Thus, disentangling supply and demand factors behind price and quantity indicators can provide a richer framework for analysis.

More specifically, the types of shocks on liquidity matter for growth. We find that shocks to noncore liquidity tend to have a stronger effect relative to core liquidity. This likely reflects the fact that noncore liquidity creation is highly endogenous to the economic cycle, expanding through leverage and balance sheet growth with lower prices, and correspondingly, fueling perceptions of lower risks and even greater leverage. In particular, the perception of risk (as reflected by the price of funding) may be at its lowest when risk exposures (as reflected by financial sector liabilities) are highest. The impact of a negative shock to noncore liquidity can therefore be sizeable as market participants delever and reduce balance sheet exposures.

In addition, we find that the source of liquidity shocks—whether demand or supply-driven – matter. Supply shocks to noncore liquidity are procyclical to growth; this is intuitive: greater liquidity creation and balance sheet expansion boost economic activities. Meanwhile, demand shocks are countercyclical to growth. The intuition here is best explained by the stabilizing effect of demand-driven increases in liquidity: as prices rise, the cost of funding increases accordingly, dampening demand and correspondingly, balance sheet expansion. Thus, the ability to interpret liquidity developments in terms of supply and demand is important for monitoring both the price and quantity of liquidity and the underlying financial and economic conditions.

This work points to a number of notable further areas of work. In particular, the identification of supply and demand hinges on the accuracy of the price indicators, which can be difficult to establish. Furthermore, more work is needed to establish the properties of global liquidity, including the role of structural breaks and financial innovation.

Ultimately, there is no simple “cookbook” for understanding country responses to shocks to global liquidity—which will depend, among other things, on structure of the financial sector, openness, monetary autonomy, etc. Likewise, at the global level, policy responses to liquidity shocks will depend on the specifics and origin of the shock. In general, Goodhart’s Law reminds us of the futility of pursuing any particular monetary aggregate or indicator—as behavior of actors change, these can quickly lose whatever forecasting value they once had. Still, trying to understand supply and demand developments in funding markets can provide important information.