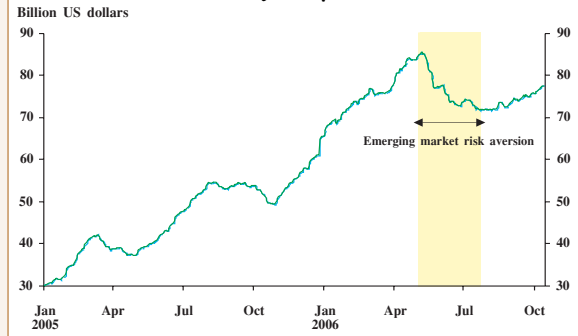


## Global liquidity

Between mid-May and mid-June 2006, emerging market economies (EMEs) faced sudden capital outflows as foreign investors shifted their exposures from high returns but riskier EMEs' assets towards more liquid assets in major markets - an incident known as 'Emerging Market Risk Aversion'. Capital outflows from 6 Asian EMEs' equity markets totalled 13.0 billion US dollars<sup>1</sup> or approximately 15.3 per cent of the accumulated inflows from the beginning of 2004 up to the start of the event. Although it lasted only for a short period, the episode brought about heightened volatility in foreign exchange and equity markets. From late June 2006 onwards, however, capital flowed back into EMEs, albeit more slowly compared to the beginning of the year.

Chart 1 Accumulated capital inflows into 6 Asian equity markets (since January 2004)



Note: 6 Asian equity markets are Thailand, Indonesia, the Philippines, India, Taiwan and South Korea

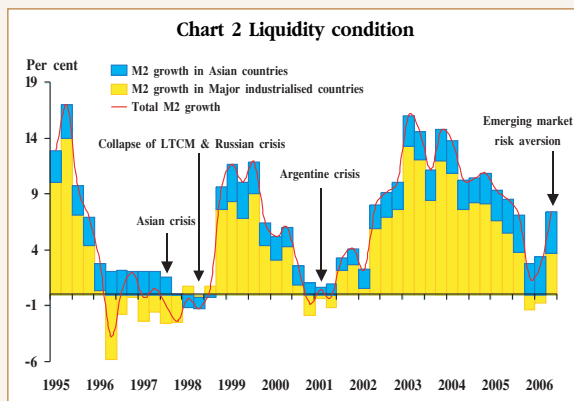
Source: Bloomberg

The recent risk aversion incident was driven by investors' concerns over their rapid accumulation of exposure to EMEs over the past few years. As the returns in major markets rose, the narrowing spread of returns between EMEs and major markets changed the risk-returns profiles of EMEs' assets. Such concerns in turn were motivated in part by

the reduction in global liquidity. With more limited funds, investors became more sensitive and cautious in their investments, which could raise volatility in global financial markets, particularly in EMEs with small markets compared to the size of capital flows. The impact of tight global liquidity on domestic financial markets highlights global liquidity as an issue of particular concern.

### Recent global liquidity condition

M2 growth<sup>2</sup> over the past 10 years appears to be cyclical, particularly in the case of industrialised countries. Moreover, contractions in liquidity appears to coincide with financial crises, for instance, the Asian financial crisis and the Russian crisis during 1997-1998, the collapse of Long-term Capital



Note: 1) Major industrialised countries comprise the US, euro area, UK and Japan

2) Asian countries comprise China, NIEs-4 (Hong Kong, Taiwan, Singapore and Korea) and ASEAN-4 (Thailand, Malaysia, Indonesia, and the Philippines)

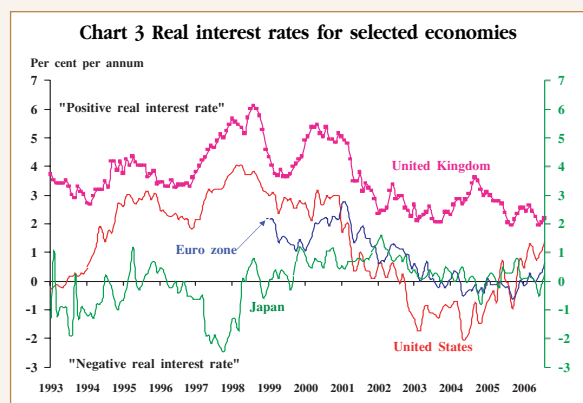
3) Converted at the average market exchange rate

Source: Bloomberg and CEIC

<sup>1</sup> From 12 May 2006 to 31 July 2006

<sup>2</sup> Besides M2 growth, other measures of global liquidity are also available. For example, Goldman Sachs Financial Condition Index (GSFCI) is calculated from various indicators including the London Interbank Offer Rate (LIBOR) of selected countries. Merrill Lynch calculates global liquidity of the US dollar by adding countries' international reserves deposited at the Federal Reserve, mainly in the form of Treasury securities, to US monetary base. International reserve accumulation could be used to proxy global liquidity in a broad sense, assuming that not all foreign exchange accumulation can be sterilised by central banks.

Management (LTCM) in 1998, and the Argentine crisis in 2001. Despite the lack of concrete evidence on causality from reduced global liquidity to financial crises, a tight liquidity condition could affect investors' decision process in 2 ways. First, reduced global liquidity may alter the trade-off between risk and return. When liquidity is tight, investors would require a higher rate of return to compensate for liquidity risk. Moreover, as liquidity diminishes, liquidity risk for most investors rises together, which consequently induces currencies and assets reallocation. For example, disturbed confidence could prompt capital outflows or sudden stops of capital inflows from a country, drying up liquidity in such a way that eventually leads to financial troubles.



Source: Bloomberg

Directly related to global liquidity cycle, especially during the past 2 years, is the conduct of monetary policy. Tightened monetary policy has been clearly reflected in the upward trend of policy rates in many countries. For instance, the fed funds rate rose from 1.00 per cent in mid-2004 to 5.25 per cent at present. Meanwhile, the policy rate of the euro area has been raised from 2.00 per cent in late-2005 to 3.25 per cent thus far. In Asia, especially in Thailand, Indonesia and the Philippines, policy rates have also been hiked several times during the past 2 years to alleviate inflationary pressure coming from higher oil prices. During this monetary policy tightening period, global liquidity concurrently declines. M2 growth in US dollar terms<sup>3</sup> sharply fell from an average of 9 percent in 2004 to below 2 percent in 2005 Q4 and 2006 Q1, which could partly be accounted for by the transmission from higher policy rate to the economy and subsequently liquidity.

### The effects of liquidity condition on financial markets

Looking ahead, global liquidity could tighten further due to ongoing monetary policy tightening in some countries, particularly Japan, which has been a major international funding source for the past several years,<sup>4</sup> as well as European countries. Furthermore, the US is likely to maintain fed funds rate at the current level for some time. Should global liquidity continue to tighten and meanwhile investors' risk aversion shifts, financial market volatility may be heightened particularly in the case of foreign exchange and equity markets. The impact of such volatility needs to be taken into consideration by all those involved.

<sup>3</sup> Converted at the average market exchange rate over that period

<sup>4</sup> During the past decade, Japan experienced a prolonged period of deflation. The Bank of Japan had to maintain its policy rate at zero per cent and implemented quantitative easing policy to stimulate domestic economic activities. Consequently, global liquidity increased via 2 main channels: an increase in outbound investment by Japanese investors seeking higher returns and an increase in the ability of foreign investors to borrow funds at low costs from Japanese financial institutions.