Most policy-makers did not anticipate the financial crisis of 2008. Nevertheless, in contrast to their performance during the Great Depression, central banks around the world, led by the Federal Reserve, acted decisively following the collapse of Lehman Brothers and provided huge injections of liquidity into the financial markets, thereby preventing a far worse outcome. *International Liquidity and the Financial Crisis* compares the 2008 crisis with the disaster of 1931 and explores the similarities and differences. It considers the lasting effects of the crisis on international liquidity, the possibilities for an international lender of last resort, and the enlargement of the International Monetary Fund after the crisis. It shows that there is no clear demarcation between monetary and macro-prudential policies, and discusses how central banks need to adapt to a new environment in which global liquidity is much scarcer.

William A. Allen worked in the Bank of England from 1972 to 2004, where he was Head of the Money Market Operations Division, Head of the Foreign Exchange Division and Director for Europe. Since 2004 he has been an honorary senior visiting fellow of Cass Business School in London and has published widely on central banking and international finance. He is a specialist adviser to the House of Commons Treasury Committee and a consultant to the International Monetary Fund.
International Liquidity and the Financial Crisis

WILLIAM A. ALLEN
Contents

List of figures  page vii
List of tables  ix
Preface  xiii

1  Introduction  1

2  The domestic liquidity crisis in the USA  12
1  The flight to liquidity and safety  12
2  The collateral squeeze  14
3  Commercial bank balance sheets after the Lehman Brothers failure  18
4  Secured funding and the liquidity management of large broker-dealers  20
5  Central bank reserve management  27
6  The collateral squeeze and the inflow of funds from abroad  30

3  International liquidity crises outside the USA  32
1  International flows of funds during the crisis of 2008  32
2  Currency-specific liquidity shortages  33
3  The unwinding of carry trades  41
4  The scale of the global crisis  43

4  Effects on financial markets outside the USA  49
1  Money and swap markets  49
2  Incidence of currency-specific liquidity shortages – evidence from market indicators  52
3  Effects of the unwinding of carry trades in destination countries  61

5  The theory of central banking before the crisis and the practice of central banking during the crisis  68
1  Pre-crisis central bank behaviour  68
2  The nature of central banks’ reactions to the crisis  74
3  Scale of central banks’ reactions  77
## Contents

6 Swap lines 83  
1 History 83  
2 Which swap networks were set up during the crisis? 86  
Appendix to Chapter 6 96  

7 Which countries received swap lines? 99  
1 Risks to liquidity providers 99  
2 Objectives of liquidity takers 103  
3 Relationship between currency shortages and probability of receiving a swap line 104  

8 Did the swap providers achieve their objectives? 113  
1 Experiences of swap providers 113  
2 Comparison of the experiences of swap providers 126  

9 How did the swap lines affect the recipients? 128  
1 Large international financial centres 128  
2 Smaller international financial centres 137  
3 Countries which are not international financial centres 144  
4 Summary 156  

10 Propagation and scale of the 1931 crisis 158  
1 International flows of funds in 1931 158  
2 Flight to liquidity and safety 164  
3 Central bank reserve management 166  
4 The scale of the liquidity crisis 168  

11 The management of the 1931 crisis 173  
1 The gold standard in theory 173  
2 The gold standard in 1931 175  

12 A comparison of 1931 and 2008 186  
1 Nature and scale of the crises 186  
2 Propagation and management of the crises 189  

13 International liquidity management 197  
1 Reserve-holding behaviour since the end of Bretton Woods 197  
2 The effects of the crisis on reserve-holding behaviour 201  
3 Post-crisis reserve accumulation 210  
4 The global demand for liquidity and the concept of monetary policy 211  

Data appendix 217  
References 227  
Index 240
Figures

1.1 The ‘TED spread’  page 3
1.2 World activity indicators  4
2.1 Central banks’ total assets, 2007–09  13
3.1 BIS reporting banks’ local claims in foreign currencies vis-à-vis all sectors  36
3.2 BIS reporting banks’ cross-border claims in foreign currencies vis-à-vis all sectors  37
3.3 Net outstanding US dollar cross-border claims on BIS reporting banks by economies shown  38
3.4 Net outstanding euro cross-border claims on BIS reporting banks by economies shown  39
3.5 Net outstanding Japanese yen cross-border claims on BIS reporting banks by economies shown  39
3.6 Net outstanding pound sterling cross-border claims on BIS reporting banks by economies shown  39
3.7 Net outstanding Swiss franc cross-border claims on BIS reporting banks by economies shown  40
3.8 Net outstanding cross-border claims on BIS reporting banks by groups of emerging economies shown  40
4.1 Covered interest rate differentials against the US dollar, three-month maturity  53
4.2 Covered interest rate differentials against the euro, three-month maturity  56
4.3 Covered interest rate differential of the won against the yen, three-month maturity  58
4.4 Cross-currency basis swap spreads against the US dollar, one-year maturity  58
4.5 Cross-currency basis swap spreads against the euro, one-year maturity  59
4.6 Cross-currency basis swap spreads against the US dollar, one-year maturity  60
### List of figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.7</td>
<td>Exchange rates against the US dollar</td>
<td>61</td>
</tr>
<tr>
<td>4.8</td>
<td>Exchange rates against the euro</td>
<td>62</td>
</tr>
<tr>
<td>4.9</td>
<td>Exchange rates against the Swiss franc</td>
<td>63</td>
</tr>
<tr>
<td>4.10</td>
<td>Exchange rates against the yen</td>
<td>63</td>
</tr>
<tr>
<td>4.11</td>
<td>New Zealand dollar trade-weighted index</td>
<td>64</td>
</tr>
<tr>
<td>4.12</td>
<td>New Zealand short-term interest rates and bond yields</td>
<td>64</td>
</tr>
<tr>
<td>4.13</td>
<td>Swiss franc value of ‘other foreign currency’ housing loans to individuals in Hungary</td>
<td>66</td>
</tr>
<tr>
<td>4.14</td>
<td>Swiss franc value of foreign currency housing loans to individuals provided by Polish MFIs</td>
<td>66</td>
</tr>
<tr>
<td>6.1</td>
<td>Swap networks created in 2007–09</td>
<td>87</td>
</tr>
<tr>
<td>8.1</td>
<td>US commercial banks’ net debt to related foreign offices and Fed swaps outstanding</td>
<td>117</td>
</tr>
<tr>
<td>8.2</td>
<td>Use of SNB repo facilities by domestic and foreign banks</td>
<td>122</td>
</tr>
<tr>
<td>8.3</td>
<td>Nominal effective exchange rate indices</td>
<td>123</td>
</tr>
<tr>
<td>9.1</td>
<td>US dollar auction allotments</td>
<td>131</td>
</tr>
<tr>
<td>9.2</td>
<td>Foreign holdings of Korean local-currency bonds</td>
<td>145</td>
</tr>
<tr>
<td>9.3</td>
<td>Net position of foreign residents in Mexican government securities, 2006–09</td>
<td>149</td>
</tr>
<tr>
<td>9.4</td>
<td>Foreign holdings of Hungarian local-currency government securities</td>
<td>150</td>
</tr>
<tr>
<td>10.1</td>
<td>Gold stock and net holdings of foreign exchange</td>
<td>167</td>
</tr>
<tr>
<td>13.1</td>
<td>World foreign exchange and gold reserves as a percentage of world gross product</td>
<td>198</td>
</tr>
<tr>
<td>13.2</td>
<td>Quarterly changes in world foreign exchange reserves, 2000–11</td>
<td>208</td>
</tr>
</tbody>
</table>
Tables

2.1 The balance sheet of a shadow bank  page 15
2.2 US commercial banks: changes in selected balance sheet items from 3 September 2008 to end-December 2008  19
2.3 Condensed balance sheet of Morgan Stanley, 2007–08  23
2.4 Morgan Stanley’s identified net collateral position, 2008–09  25
2.5 Bank deposits in foreign exchange reserves, 2007–09  29
3.1 Exchange rate-adjusted changes in commercial banks’ net external liabilities in the second half of 2008  33
3.2 Reporting banks’ local assets in foreign currency, end-December 2008  35
3.3 Selected assets and liabilities of banks located in Japan – changes from end-July 2008 to end-December 2009  42
3.4 International short-term indebtedness, 2008–09  44
3.5 Significant falls in bank deposits, 2007–10  46
3.6 Changes in bank deposits in and around the 2008–09 financial crisis  47
4.1 Average covered interest rate differentials versus US dollar, 16/09/2008–02/01/2009  55
5.1 Central bank official interest rates, 2008  78
5.2 Changes in central bank assets, 2008–09  79
6.1 Language of swap announcements by the People’s Bank of China  95
7.1 Results for probit and logit models by currency  106
7.2 Probit model for probability of receiving US dollar swap line  108
7.3 Probit model for probability of receiving US dollar swap line, taking into account time zone difference  110
<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.4</td>
<td>Drawings on US dollar swap lines from the Federal Reserve at end-2008</td>
</tr>
<tr>
<td>8.1</td>
<td>Drawings of US dollars on Fed swap lines</td>
</tr>
<tr>
<td>8.2</td>
<td>Announcements of swap lines and covered interest differentials against US dollar</td>
</tr>
<tr>
<td>8.3</td>
<td>Selected items from Eurosystem balance sheet</td>
</tr>
<tr>
<td>8.4</td>
<td>Amounts of Swiss francs provided by Swiss National Bank through swaps</td>
</tr>
<tr>
<td>8.5</td>
<td>Bank of Japan foreign currency assets and drawings on the swap line with the Fed</td>
</tr>
<tr>
<td>9.1</td>
<td>Summary statistics: countries which received swap lines</td>
</tr>
<tr>
<td>9.2</td>
<td>Foreign currency auction allotments and foreign exchange reserves in the euro area</td>
</tr>
<tr>
<td>9.3</td>
<td>US dollar auction allotments and foreign exchange reserves in Switzerland</td>
</tr>
<tr>
<td>9.4</td>
<td>US dollar auction allotments and foreign exchange reserves in the United Kingdom</td>
</tr>
<tr>
<td>9.5</td>
<td>Reserve Bank of Australia balance sheet – selected items</td>
</tr>
<tr>
<td>9.6</td>
<td>Denmark: influences on international liquidity</td>
</tr>
<tr>
<td>9.7</td>
<td>Sveriges Riksbank balance sheet – selected items</td>
</tr>
<tr>
<td>9.8</td>
<td>Norges Bank balance sheet – selected items</td>
</tr>
<tr>
<td>9.9</td>
<td>Hungary: selected data</td>
</tr>
<tr>
<td>9.10</td>
<td>Hungary: cross-currency basis swap spreads against the euro</td>
</tr>
<tr>
<td>9.11</td>
<td>Poland: cross-currency basis swap spreads against the euro</td>
</tr>
<tr>
<td>9.12</td>
<td>Poland: foreign exchange reserves net of predetermined outflows</td>
</tr>
<tr>
<td>10.1</td>
<td>Changes in gold and foreign exchange reserves in 1931</td>
</tr>
<tr>
<td>10.2</td>
<td>Changes in central and commercial bank balance sheets in gold-losing countries in 1931</td>
</tr>
<tr>
<td>10.3</td>
<td>Changes in central and commercial bank balance sheets in gold-receiving countries in 1931</td>
</tr>
<tr>
<td>10.4</td>
<td>Gross amount of short-term international indebtedness of the United States and European countries</td>
</tr>
<tr>
<td>10.5</td>
<td>Gross amount of short-term international indebtedness of the United States and European countries</td>
</tr>
<tr>
<td>10.6</td>
<td>Commercial bank deposits, 1930–35</td>
</tr>
<tr>
<td>11.1</td>
<td>Central bank discount rates, 1930–31</td>
</tr>
</tbody>
</table>
List of tables

11.2 Changes in central bank assets, 1931 180
12.1 Central bank liquidity provision in the two crises 194
13.1 Large foreign exchange reserve holdings 199
13.2 Techniques for providing liquidity assurance 204
13.3 Large increases in foreign exchange reserves, end-2008 to end-2010 209
Data appendix table 1: Central bank assets: tests of comprehensiveness of estimates based on League of Nations data 225
Preface

This book draws very heavily on a programme of work which Dr Richhild Moessner of the Bank for International Settlements and I embarked on in late 2008, to explore the effects of the financial crisis on international liquidity flows and the ways in which central banks and governments were responding to the crisis. Our work has been released in articles in economics journals and working papers, details of which can be found in the references at the end of the book.

The purpose of the book is to provide a coherent account of the effects of the crisis on international liquidity. Dr Moessner and I have been equal partners in the research on which the book is largely based. She has very generously allowed me to draw freely on our joint work and has been characteristically supportive of the book project. I therefore owe her a great deal. The book also contains some material and expresses some views which are mine alone and for which Dr Moessner bears no responsibility.

I am very grateful to the Bank for International Settlements for its hospitality, and for allowing me to use material which it has published. The views I express in the book are mine and do not necessarily reflect those of the BIS. The book also draws on papers published in Central Banking, the Financial History Review, the Journal of Financial Transformation, Revista de Economia Institucional and World Economics. I am grateful to the publishers for permission to use this material.

Many other people have assisted the work programme by means of comments on papers, discussions at seminars, statistical advice and conversations on the subject matter. They include Bob Aliber, Edmund Allen, Lucy Allen, Rosalind Allen, Naohiko Baba, Peter Bernholz, Bilyana Bogdanova, Claudio Borio, Maria Canelli, Matt Canzoneri, Forrest Capie, Stephen Cecchetti, Jae-Hyun Choi and other officials of the Bank of Korea, Henning Dalgaard, Petra Gerlach, Homero
Preface


I owe a very great debt to the late Michael Dealtry, who spent much time in teaching me about the international monetary system.

My greatest debt is to my wife Rosemary, for her steadfast support through thick and thin and for tolerating my frequent physical and mental absences. The book is dedicated to her.