

# US Economy: Liquidity boom and looming crisis

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Economic growth in the US slowed to 1.3% in the first quarter (Q1) of 2007, the worst performance in four years of an overextended debt bubble. Yet the Dow Jones Industrial Average (DJIA) rose to an all-time intra-day high of 13,284.53 to close at 13,264.62 last Friday, rising more than 1,000 points or 9% in the same period.

The DJIA is now 82% higher than its low of 7,286.27 on October 9, 2002, during which US gross domestic product (GDP) grew only 38%.

## The 10-year cycle of financial crises

The historical pattern of a 10-year rhythm of cyclical financial crises looms as a menacing storm cloud over the financial markets.

The 30% US market crash of 1987, in which investors lost 10% of 1987 GDP, was set off by the 1985 Plaza Accord to push down the Japanese yen with an aim of reducing the growing US trade deficit with Japan. The 1987 crash was followed 10 years later by the Asian financial crisis of July 2, 1997, with all Asian economies going broke, and some stock markets such as Thailand's losing 75% of their value, and Hong Kong having to raise its overnight deposit rate to 500%, trying to defend the fixed exchange rates of their currencies.

In South Korea, Daewoo Motors, facing bankruptcy, was forced to be taken over on the cheap by General Motors. In Indonesia, the Suharto government fell because of social instability arising from the financial crisis. A wave of deflation spread over all of Asia from which Japan, already in recession since 1987, has yet to fully recover two decades later. In the United States, the DJIA dropped 7.2% on October 27, 1997, and the New York Stock Exchange had to suspend trading briefly to break the free fall.

Now in 2007, a looming debt-driven financial crisis threatens to put an end to the decade-long liquidity boom that has been generated by the circular flow of trade deficits back into capital-account surpluses through the conduit of US dollar hegemony.

While the specific details of these recurring financial crises are not congruent, the fundamental causality is similar. Highly leveraged short-term borrowing of low-interest currencies was used to finance high-return long-term investments in high-interest currencies through "carry trade" and currency arbitrage, with projected future cash flow booked as current profit to push up share prices.

In all these cases, a point was reached where the scale tipped to reverse the irrational rise in asset prices beyond market fundamentals. Market analysts call such reversals "paradigm

shifts". One such shift was a steady fall in the exchange value of the US dollar, the main reserve currency in international trade and finance, to cause a sudden market meltdown that quickly spread across national borders through contagion with selling in strong markets to try to save hopeless positions in distressed markets.

There are ominous signs that such a point is now again imminent, in fact overdue, in globalized markets around the world.

### **Weak economic data**

US GDP growth of 1.3% for Q1 2007 announced by the Commerce Department on April 27 was weaker by almost half than the 2.5% growth rate logged in the fourth quarter (Q4) of 2006. The main culprit was a housing slump caused by a meltdown in the subprime mortgage sector.

US home-building dropped by 17% on an annualized basis and is expected to worsen. That happened after investment in home-building was slashed at an even deeper 19.8% pace in Q4 2006. There are no signs that the housing slump has hit bottom, or that its adverse impact on the economy and the financial market has been fully felt globally.

Deprived of expanding wealth effect by falling home prices, US consumer spending was up only 0.3% in April on a 0.7% rise in personal income, while core inflation was muted. Consensus estimates had been for a 0.5% rise in spending on a 0.6% gain in income. Adjusted for inflation, consumer spending was actually 0.2% lower month on month, its biggest drop since September 2005, suggesting that without additional cash-out refinancing on rising home values, high energy prices might have finally dampened consumer willingness and ability to spend on non-energy purchases.

GDP measures the value of all goods and services produced in a domestic economy. It is considered by economists and policymakers to be the best overall barometer of economic health. US economic performance in Q1 2007 was weaker by 0.5 percentage point than even the forecast low expectation of 1.8%.

US Federal Reserve chairman Ben Bernanke and Treasury Secretary Henry Paulson both made obligatorily optimistic statements denying the likelihood of a recession this year, even though former Fed chief Alan Greenspan has openly put the odds at one in three.

Even though the US economy slowed in Q1 2007, inflation pressure continues to complicate Fed policy deliberation. Core prices, excluding food and energy, rose at a rate of 2.2% in Q1 2007, up from a 1.8% pace in Q4 2006. Overall prices jumped by 3.4% in Q1 2007, compared with a 1.0% decline on an annualized basis in Q4 2006.

### **The Fed's dilemma**

While Federal Reserve policymakers traditionally view inflation as the main danger to the economy, they optimistically predict that inflation will moderate as the US central bank stays with a tight monetary policy.

Since last June 29, the Federal Reserve has not moved the Fed Funds Rate target, the interest rate at which depository institutions lend balances to each other overnight. Before that, it had lifted rates 17 times at a "measured pace" of 25 basis points over a 36-month

period, for a total 425 basis points to ward off inflation. The current Fed Funds Rate target is 5.25%, from a low of 1% set on June 25, 2003. Many economists and money-market participants predict that the Fed will continue to leave rates unchanged at its next meeting this Wednesday.

The Fed's stated goal is to cool an overheated economy sufficiently to keep inflation in check by raising short-term interest rates, but not so much as to provoke a recession. Yet in this age of finance and credit derivatives, the Fed's interest-rate policy no longer holds dictatorial command over the supply of liquidity in the economy. Virtual money created by structured finance has reduced all central banks to the status of mere players rather than key conductors of financial markets. The Fed now finds itself in a difficult position of being between a rock and a hard place, facing a liquidity boom that decouples rising equity markets from a slowing underlying economy that can easily turn toward stagflation, with slow growth accompanied by high inflation.

### **Wealth effect exhausted, dissipated by maldistribution**

The wealth effect from rising equity prices has been caused directly by a debt bubble fed by overflowing liquidity created beyond the Fed's control, by the US trade deficit denominated in dollars returning to the US as capital-account surpluses. This debt-driven liquidity boom is exacerbated by a falling dollar, which artificially inflates offshore earnings of transnational corporations to support rising share prices pushed up by too many dollars chasing after a dwindling supply of shares caused by corporate share-buyback programs paid for with low-interest loans.

Further, the wealth effect from the equity bubble has not been broadly distributed, resulting in a boom in the luxury consumer market catering to the beneficiaries of capital gain while the broad consumer market catering to wage earners stalls. The newly rich in the financial sectors are buying multimillion-dollar first and second and even third homes, while average workers are buying cheap T-shirts and shoes made in China. The highest-paid hedge-fund manager took home US\$1.7 billion in 2006, while the average US worker's annual pay was \$28,000. The minimum wage was \$5.15 per hour. If the minimum wage had risen at the same rate as chief executive officers' pay, it would have been \$22.61 per hour in 2006.

### **Wages decline while returns on capital soar**

Another troubling bit of economic news came from the US Labor Department, that while the DJIA rose 5.9% in Q1 2007 with inflation at 2.2 %, wages and benefits grew by only 0.8%, down slightly from the low 0.9% increase in Q4 2006. Wages and salaries went up 1.1%, the fastest since 2001, but benefit costs edged up only 0.1%, the slowest since Q1 1999 despite rising medical costs, reflecting a trend by companies to maximize their earnings by abdicating their social responsibilities to their workers and to society.

Labor's share of the US GDP growth of 1.3% amounted to negative-2.6% after a 3.4% inflation adjustment, while capital's share was positive 2.5%. If labor's share of GDP growth were to be kept neutral after inflation, capital's share would register negative-0.1%. This is not good news to anyone except the Fed, which views rising wages as inflation. And if labor's share of GDP growth remains negative, companies will not be able to sell their products and will be forced to lay off workers to maintain profit margins, thus slowing economic growth still further.

### **Jobless expansion**

US consumer spending rose at a 3.8% pace in Q1 2007, slightly weaker than the 4.2% growth rate logged in Q4 2006. This signals the depletion of the wealth effect from asset inflation.

US job creation slowed to its weakest pace in more than two years in April as layoffs extended beyond manufacturing and construction to retail trade. Unemployment rose to 4.5% in April from 4.4% in March, with only 88,000 new jobs created in April, compared with an increase of 177,000 in March.

The slowdown in job creation reflects recent economic weakness but is likely to be viewed perversely by the Federal Reserve as a welcome sign that wage inflation pressures are easing. Heavy job losses in the retail sector were a sign of a “broad-based deceleration” in employment in the service sector, underlining fears about the resilience of consumer spending. The retail sector shed 26,000 workers, while house builders cut 11,000 positions and manufacturers eliminated 19,000.

In April, US private-sector jobs registered the weakest growth in four years, increasing by only 64,000. Service firms added 106,000 jobs, goods producers cut 42,000; small businesses created 45,000 jobs and about 24,000 government jobs were added, adding up to a job growth of 88,000, lower than the 100,000 forecast. Unit labor costs, a much-watched inflation signal, rose at only 0.6% annualized, way below expectations of 2.1%. In the manufacturing sector, while jobs continued to decline, the cost figures were higher: productivity was up 2.7% while unit labor costs grew as well at 2.7%, reflecting growth in high-tech, big-ticket manufacturing such as commercial aircraft where the US still commands global competitiveness.

This jobless recovery is still 6.7 million private-sector jobs short of the typical recovery 67 months after a previous business-cycle peak.

### **New geometry of debt securitization**

The mortgage sector before the age of securitization was shaped like a cylinder in which risk was evenly spread throughout the entire sector, thus all mortgages share the aggregate cost of default. This even spread of risk premium is viewed as market inefficiency.

Securitization through collateralized debt obligations (CDO) permits the unbundling of generalized risk embedded in all debt instruments into tranches of escalating risk levels with compensatory higher returns, and in the process squeezes additional value out of the same mortgage pool by maximizing risk/return efficiency.

The geometry of CDO securitization transforms the cylinder shape of the mortgage sector to a pyramid shape, with the least risky tranches at the top and the more risky tranches with commensurate premiums toward the bottom, so that a greater aggregate risk premium can be squeezed out by the security packagers and investors as profit. This extra value, when siphoned off repeatedly from the overall mortgage pool, requires an ever larger base of subprime mortgages in the new pyramid shape, thus increasing the systemic risk further.

Subprime borrowers are no longer just low-income borrowers. They include high-income borrowers whose incomes and collateral value do not provide sufficient reserve for sudden changes in market conditions. A subprime borrower is one who over-borrows beyond prudent standards. The extra risk-premium value thus taken out of the mortgage sector

contributes to the increase in liquidity to feed the debt market further, pushing the low credit standard of subprime lending further down. Once prime-credit customers have borrowed to their full credit limits, growth can only come from lowering credit standards, turning more prime borrowers into subprime borrowers.

This is the structural unsustainability of CDO securitization, irrespective of the state of the economy, since risk of default is shifted from the state of the market to the direction of the market. Any slight turn in market direction will set off a downward-spiral crisis. The initial upward phase of this cycle is euphoric, like any addiction, but the pain will come as surely as the sun will set in the downward phase.

Not many economists or regulators have yet focused on this structural defect of CDO securitization. The recent congressional hearings on subprime mortgages completely missed this obvious structural flaw.

### **China's foreign reserve mirage**

China's latest foreign-reserves data showed that there is as much as \$73 billion in unexplained new reserves. The People's Bank of China (PBoC), the central bank, now holds more than \$1.2 trillion in foreign reserves, the most among the world's central banks, except the US Federal Reserve, which can create dollars at will and therefore needs not hold any foreign reserves.

The Wall Street Journal explained the Chinese foreign-exchange puzzle by suggesting that the "leading suspect is a possible series of foreign-currency swaps by Chinese banks". The Journal reported that foreign-exchange trading among Chinese banks in 2006 was "more active than widely known".

The PBoC did not provide any comments or an explanation. The question is whether the funds were in fact swaps, which would mean only minor implications for the broader economy, or if they actually were dollar inflows, which could further stimulate an overheated economy.

Dollar inflows would require further monetary tightening by the PBoC, on top of the numerous hikes in interest rates and bank reserve requirements over the past year, to reduce the risks of an equity bubble fueled by expanded money supply. On April 29, China raised the required bank reserve for the fourth time this year, reducing the amount available for bank lending in a new effort to cool an investment boom that could spark a financial crisis. The order by the central bank came on top of successive interest-rate hikes and investment curbs imposed on real estate, auto manufacturing and other industries over the past year.

The effort has had only limited success in slowing the frenzy growth of investment. The amount of reserves that lenders must keep with the central bank was raised 0.5 percentage point to 11% of their deposits, from 7.5% of deposits, before the first increase last June. The increase to 11% from 10.5% will take effect next Tuesday, May 15.

The central bank said, "The increase in bank reserve is aimed at stepping up liquidity management of the banking system and to guide a reasonable growth of credit." The Consumer Price Index rose 3.3% in March, above the Chinese government's 3% target. And fixed-asset investment countrywide grew a robust 23.7% during March. The economy grew

10.7% in 2006, the highest rate since 1995. The central bank said China's international balance-of-payments problem is boosting excessive liquidity in the Chinese economy.

### **China's phantom trade surplus**

Chinese global trade surplus hit a record \$177.5 billion in 2006, up 74% from the previous year. Take away \$73 billion of capital inflow and \$60 billion in returns on foreign capital, and China's net trade surplus was only about \$40 billion in 2006. By comparison, Japan's trade surplus was \$168 billion and Germany's was \$146 billion.

The US trade deficit with China widened to a record \$233 billion in 2006, out of a global total of \$857 billion. If the US reduces its trade deficit with China, China will reduce its own trade deficit with its other trading partners, without much impact on the US global trade deficit.

### **Dollar hegemony distorts Chinese economy**

The adverse effect of dollar hegemony on the Chinese economy is becoming clearly visible. As the dollar-denominated trade surplus mounts, the PBoC is forced to tighten domestic macro-monetary measures to neutralize the increased yuan money supply resulting from buying up the surplus dollars in the Chinese economy with the local currency. The Chinese trade surplus is causing a monetary bubble in the Chinese economy while real wealth is leaving China in the form of exported goods, causing a rising money supply chasing after a shrinking asset base.

The dollars that the PBoC buys with Chinese yuan go to finance the US debt bubble. The new yuan money, instead of going to finance development of the interior region in China, is attracted by speculative real estate and equities, pushing prices up beyond fundamentals. The Shanghai Stock Exchange Composite (SHCOMP) rose 27% in a month after a 7% drop that spooked world markets in late February, including a 3% drop in the Dow. The Shanghai real-estate bubble keeps growing in a speculative frenzy while rural villages are starving for capital.

### **China re-exports dollars**

Led by China and Japan, all the exporting economies, saddled with dollars that cannot be used in their domestic economies without creating a monetary crisis, are fueling a global liquidity boom focused on the importing economies led by the US, where the dollar is a legal tender that involves no conversion cost. This global liquidity boom denominated in dollars will cause inflation in the dollar economy that will spill over to all other economies.

The US real-property boom has created huge service demands that lead to tight labor markets. The global commodity bubble of the past three years has increased costs of living and production, adding more than 5% to global GDP growth. Although commodity inflation has been absorbed through low-interest consumer borrowings and lower-wage labor in the past, it is now finally showing up as higher-cost factor inputs.

China has kept the global cost of manufacturing artificially low by not paying adequately for pollution control and worker wages and benefits, including inadequate retirement provisions. Domestic political pressure within China is forcing the government to normalize full production cost, which will boost global inflation.

## **Financial globalization and inflation**

Financial globalization has increased the elasticity of macro-trends, causing a delayed effect in inflation. But it has not banished inflation altogether, nor has it eliminated the business cycle. It has merely extended the historical cycle from seven years to beyond 10 years.

Global inflation has picked up by 60 basis points in the past four quarters. If the trend continues, major central banks will have to focus on fighting inflation by cooling the liquidity boom. To avoid a drastic market collapse, anti-inflation measures will need to be implemented at a “measured pace”, which means it may take as long as two years to take effect. The problem is that the system, which operates on ever rising asset values, cannot weather a two-year-long anemic growth. Thus even a soft landing will quickly turn into a crash.

Bonds will be the first asset class to decline in market value in this anti-inflation cycle, which will eventually also affect other asset classes. As the flat or inverted yield curve spikes upward back to normal, making the spread between long-term and short-term rates wider, the commodity bubble will burst, followed by the stock market in a general deflation. Such a deflation cannot be cured by the Fed adopting inflation-targeting through printing more dollars because inflation-targeting is merely transmitting price deflation to a monetary devaluation.

Globalization and hedging have merely postponed, not eliminated, cyclical inflation. Globalization has stunted wage inflation as the main transmission between monetary growth and inflation. Hedging only reassigns unit risk to systemic risk. It does not eliminate risk. Instead, excessive liquidity fuels asset appreciation beyond economic fundamentals. To generate demand from the wealth effect, appreciated value must be monetized through debt. As debt rises, systemic risk rises with it. As globalization spreads demand growth around the world, inflation has taken longer than normal to show up in outdated data interpretation.

The burst of the tech bubble, the shock of September 11, 2001, and the manufacturing and outsourcing of information technology caused sharp disinflation in 2002 to neutralize debt-driven dollar inflation. The average dollar inflation in the economies of the Organization for Economic Cooperation and Development (OECD) decelerated from 3.2% in second quarter of 2001 to 1.1% in Q3 2002. The threat of dollar deflation caused the Fed to cut the Fed Funds Rate to 1% on July 9, 2003, and kept it there for 12 months until July 7, 2004, while the Bank of Japan maintained a zero interest rate. This in turn led to a massive liquidity boom that fed an escalating US trade deficit.

Before the emergence of dollar hegemony, through which it became possible to finance the US trade deficit with a US capital-account surplus, then-Fed chairman Paul Volcker had to raise the Fed Funds Rate to an all-time high of 19.75% on December 17, 1980, to curb stagflation caused by a rising trade deficit. Five years later, in 1985, Volcker engineered the Plaza Accord to force the Japanese yen up against the dollar to curb the US trade deficit with Japan, promptly pushed the Japanese economy into sharp deflationary depression from which Japan has not yet fully recovered. Volcker’s victory over US inflation was won by forcing deflation on Japan.

## **Global liquidity boom sourced by dollar supply increase**

The fountainhead of the global liquidity boom is in the vast increase of the supply of US dollars, both as a result of Fed monetary policy and of dollar-denominated structured finance under dollar hegemony. This liquidity boom has helped create demand through inflating asset markets.

The wealth effect of property inflation produced both producer and consumer spending power released by debt. Commodity inflation has given producer economies, such as oil states, windfall incomes to invest in the advanced economies. Declining cost of capital fueled a new wave of financial expansion through private-equity and hedge-fund acquisitions financed with high leverage.

### **What is liquidity and how is a liquidity boom created?**

Liquidity is affected by a monetary environment created by central-bank policies and actions.

Lowering interest rates increases liquidity. Easing money-supply measures relative to growth in nominal economic activity also increases liquidity. The level of liquidity in corporate or individual balance sheets relates to cash and credit positions with which to invest or spend. But availability of money alone does not create liquidity, which requires a market in which assets can be bought and sold without regulatory restrictions or causing fundamental shifts in price levels.

The demand for assets relative to their supply also affects liquidity. Market confidence fundamentally affects liquidity, which depends on states of mind of market participants relating to appetite for risk-taking.

Hedge funds contribute significantly to the increase of liquidity by enlarging investor appetite for risk-taking. Collateralized debt obligations and credit derivatives have acted to expand liquidity in the credit markets through disintermediation and innovation. Banks have moved from the traditional “buy and hold” mode to the “originate and distribute” mode, whereby they distribute portfolios of credit risks and assets to other market players through securitization. Banks also act increasingly as suppliers of revolving credit independent of their deposits as they obtain additional credit protection through credit derivatives.

A liquidity boom requires the continuing confluence of all these factors, an even slight change in any of which can have an unraveling effect that puts a sudden end to it. A precipitous fall in the US dollar could trigger market sell-offs, as it did after the Plaza/Louvre Accords of 1985 and 1987, first to push down and later push up the dollar, which contributed to the 1987 crash.

Another cause of the 1987 crash was a threat by the US House of Representatives Ways and Means Committee to eliminate the tax deduction for interest expenses incurred in leveraged buyouts. Still another cause was the 1986 US Tax Act, which while sharply lowering marginal tax rates, nevertheless raised the capital gains tax to 28% from 20% and left capital gains without the protection against inflated gains that indexing would have provided. This caused investors to sell equities to avoid negative net after-tax returns and contributed significantly to the 1987 crash.

### **The danger of a liquidity bust**

Today, any one factor out of a host of interconnected factors, such as new regulation on hedge funds, or sharp changes in the yuan exchange rate against the US dollar, or an imbalance between tradable assets and available credit, etc, could bring the current liquidity boom to a screeching halt and turn it into a liquidity bust.

With finance globalization and the dominance of derivative plays by hedge funds and private-equity firms, any minor disruption could turn into a financial perfect storm that makes the collapse of Long Term Capital Management look like a tempest in a teacup.

William Rhodes, chairman, president and CEO of Citibank North America and of Citicorp Holdings Inc, wholly owned subsidiaries of Citigroup Inc, of which Rhodes is senior vice chairman, wrote in March:

During the last big adjustment that started in July 1997 in Thailand and spread to a number of Asian economies including South Korea, followed by Russia in 1998 – and led ultimately to the bailout of Long Term Capital Management, the US hedge fund – a number of today's large market operators were not yet in the mix. Today, hedge funds, private equity and those involved in credit derivatives play important, and as yet largely untested, roles.

The primary worry of many who make or regulate the market is not inflation or growth or interest rates, but instead the coming adjustment and the possible destabilizing effect these new players could have on the functioning of international markets as liquidity recedes. It is also possible that they could provide relief for markets that face shortages of liquidity. Either way, this clearly is the time to exercise greater prudence in lending and in investing and to resist any temptation to relax standards.

The five-year global growth boom and four-year secular bull market may simple run out of steam, or become oversaturated by too many late-coming imitators entering a very specialized and exotic market of high-risk, high-leverage arbitrage. The liquidity boom has been delivering strong growth through asset inflation (property, credit spreads, commodities, and emerging-market stocks) without adding commensurate substantive expansion of the real economy. Unlike real physical assets, virtual financial mirages that arise out of thin air can evaporate again into thin air without warning. As inflation picks up, the liquidity boom and asset inflation will draw to a close, leaving a hollowed economy devoid of substance.

Massive fund flows from the less experienced non-institutional, retail investors into hot-concept funds such as those focusing on opportunities in BRIC (Brazil, Russia, India and China) or in commodities, or in financial firms involved in currency arbitrage and carry trades, have caused a global financial mania in the past five quarters that has defied gravity. It will all melt away in a catastrophic unwinding some Tuesday morning.

Inflationary pressure in the US and other OECD economies makes a cyclical bear market inevitable and an orderly unwinding unlikely. Central banks cannot ease because of a liquidity trap that prevents banks from being able to find creditworthy borrowers at any interest rate. Banks could be pushing on a credit string and global liquidity could decline, causing asset-risk valuations to contract suddenly and sharply. A liquidity trap can also occur when the economy is stagnant and the nominal interest rate is close or equal to zero, and the central bank is unable to stimulate the economy with traditional monetary tools because people do not expect positive returns on investments, so they hoard cash to

preserve capital. Capital then becomes idle assets.

As the decade-long US consumption collapses from exhaustion, a secular bear market arises in which the bullish rebounds are smaller and do not wipe out the losses of the previous bear market. Because Asia's growth has been driven by low-wage exports, it will not be ready fill in as the global growth engine in time to prevent a global crash. China is just beginning to change its development model to boost worker income and household consumption and may take as long as a decade to see the full effects of the new policy. China's only option is to insulate itself from a global meltdown by resisting US pressure to speed up the opening of its financial markets. China's purchasing power is too weak to save the global economy from a deflationary depression.

A global financial crisis is inevitable. So much investment has been sunk into increasing commodity production that a commodity-market bust, while having the effect of a sudden tax cut for the consuming economies, will cause bankruptcies that will wipe out massive amounts of global capital.

A financial crisis could trigger a global economic hard landing. Global financial markets look suspiciously like a pyramid game in this overextended secular bull market. The proliferation of complex derivative products catering to short-term trading strategies that aim to get the biggest bang for the buck creates massive uncertainty surrounding leverage in the global financial system. A commodity burst could cause correlation trades to unwind in other markets, which could snowball quickly into a massive financial crisis.

When markets are hot, fund-manager companies tend to market funds aggressively, especially ones with hot concepts. Commodities, BRIC, etc, have been the hot concepts in this cycle. Tens of billions of dollars have been raised by such funds from the less experienced retail investors over the past three quarters in Japan, South Korea, Taiwan, Hong Kong, etc. This source of money has fueled rapid price appreciation in the recipient markets.

Starved of good returns in the US, long-term investors have been allocating funds to emerging-market and commodity specialists to chase the good performance. Such funds have flowed disproportionately into small and illiquid stocks, causing them to rise in rapid multiples. Their good performance attracts more funds and reinforces the virtuous cycle.

Rising leverage is another technical factor that has artificially boosted liquidity in the hot markets. Derivative products such as warrants are a major factor. Some funds leverage up to increase exposure to high-beta assets. Beta is a coefficient measuring a stock's relative volatility, a covariance of a stock in relation to the rest of the stock market. Capital preservation strategies prefer low-beta stocks. High-beta assets offer high returns for taking high risks.

Before finance globalization, if short-term dollar interest rates were higher than longer-term interest rates, a condition reflected by an inverted yield curve, US Treasury bond prices could not be boosted by carry trades between currencies. Today, borrowing short-term low-interest currency to invest in longer-term debt in high-interest currencies, thus earning the "carry", or interest rate spread, between the two types of debt denominated in separate currencies is routine. If short-term rates in the US are prohibitively high, or higher than long-term rates, then carry-traders can simply do most of their borrowing overseas in a foreign currency. Furthermore, if the 4% spread between short-term Japanese interest rates and US

T-bond yields is not sufficiently rewarding, the return can be boosted to 40% using routine 10:1 leverage.

More lucrative still, borrow in Japanese yen to invest in Brazilian or Turkish bonds, using various derivatives to hedge currency or credit risk and pass it on to counter-parties at the cost of a relatively small insurance premium. The supply of “hot money”, money that can be shifted around rapidly in response to changes in expected returns, now seems to be endless, because if monetary conditions start to get tighter in one part of the world, then the speculators can always find a source of low-cost financing somewhere else. And the Bank of Japan (BOJ), later joined by the Federal Reserve, with their zero, near-zero, or at least below-neutral interest rates, in effect underwrite the whole process.

The financial markets experienced minor shocks recently when the BOJ soaked up a lot of liquidity and hinted at the need to commence a rate-hike program. The minor shocks in fact forced the BOJ to back away from its planned monetary tightening to keep the speculative frenzy going. This is the reason the inversion of the US yield curve, which normally mean liquidity is about to contract, has not yet triggered a liquidity recession. A liquidity boom will continue as long as a major central bank with large foreign reserves, such as the BOJ, continues to price short-term credit at bargain-basement levels and leaves its borrowing window open to all comers.

The People’s Bank of China also contributes to the global liquidity boom by its willingness to continue to buy long-term US T-bonds even if rates fall.

The US current-account deficit is the key driver of the liquidity boom. Those who clamor for a reduction of the US trade deficit are unwittingly calling for a US recession.

When the ongoing meltdown in the subprime mortgage market spreads to other parts of the credit markets, the Federal Reserve will be forced to implement a monetary ease. But a liquidity trap will activate the dynamics of an inverted yield curve, with long-term rates falling faster than the Fed Funds Rate. When demand for bank reserves decreases because of a general slump in loan demand, then the Fed *has* to destroy bank reserves to prevent a collapse of Fed Funds Rate to zero.

### **Doomsday machine**

A liquidity trap can be a serious problem because the world is still plagued with excess liquidity potential: massive foreign reserves held by central banks, bulging petrodollars, hedge funds and private-equity funds, massive increases in global monetary base, \$4 trillion in low-yielding Chinese bank deposits ready for release for higher yields, \$5 trillion in low-yielding US time deposits maturing, \$10 trillion in low-yielding Japanese financial net worth, plus \$27 trillion in medium-yielding US household financial net worth waiting to be monetized for aggressive yields. A global liquidity trap of with \$50 trillion of idle assets will implode like a doomsday machine.

An US dollar exchange rate is a measure of the relative value of a foreign currency against the dollar, not the intrinsic value of the dollar. When the euro rises against the dollar, it is possible that both currencies have fallen in purchasing power, but the euro has merely fallen less than the dollar. This is what drives the liquidity boom that has been decoupled from the real economy.

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