Liquidity, Contagion Crisis

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Short-term international capital flows have often been blamed for generating contagion across countries. To analyze the welfare properties of such “hot money” we build a two-country model and analyze the effect of fragmentation – an increase in liquidity that is not allowed to flow from one country to the other. Contagion is an equilibrium phenomenon: a country with low liquidity requirements may suffer a financial crisis as its liquidity is sucked out to service the other country. But in equilibrium the converse may also happen: a country is saved from financial crisis by drawing on slack liquidity in the other country. An additional effect is that fragmentation tends to increase the joint amount of liquidity in both countries. We show that while the latter effect is always positive, the pure fragmentation effect (holding total liquidity fixed) is ambiguous. More generally, we argue that market provision of liquidity needs to be analyzed along two dimensions: the total supply of liquidity and the mobility of liquidity to the highest-valuation user. While it is widely recognized that the liquidity is a public good and, thus, under-provided in a competitive equilibrium, it does not follow automatically that competition fails on the other dimension, and that fragmentation, per se, is welfare improving.