Liquidity is at the centre of much discussion about international monetary policy and asset prices.

One commentator refers to a "global gusher" of liquidity, while another observes that: "Low-yielding currencies have been used as a world cash machine, pushing liquidity into asset markets." A US Federal Reserve governor says "liquidity is confidence".

There are far too many different concepts wrapped up in this broad idea to make it a helpful analytical or predictive tool. Semantic imprecision leads to analytical confusion. We need a clearer idea of what we mean by liquidity.

There are at least three different meanings:

* Market liquidity: the ease with which an asset can be sold, particularly whether this can be done in large volume without depressing the price.

* Institutional liquidity: an institution is liquid if its balance sheet has a high proportion of assets whose value can be quickly realised to meet debts.

* Monetary liquidity: originally liquidity referred to base money - the building block and policy instrument of the credit multiplier process. More loosely, it has come to be used as a general reflection of the stance of policy and monetary conditions. In this loose meaning, it can either be a price (an interest rate or a quantity), one of the monetary aggregates or credit.

It is among this last category that a rich melange of misconceptions and sloppy analysis has arisen.

Perhaps the most curious is a version of global liquidity that aggregates world international foreign exchange reserves and US base money; this series, described as "the world supply of dollars", is not only carried by a leading economic weekly, but is reported also by the International Monetary Fund.

There are two historical antecedents that may go some way to explain, if not justify, this strange choice. One is a residual memory of the international "dollar shortage" after World War II. The second is the old idea of "too much money chasing too few goods": some half-remembered hangover from an introductory economics lecture, with the notion that people and countries might find themselves with too much money, and would spend it, bidding up prices.

But none of this is relevant to a deregulated financial world in which people and countries hold precisely the cash or reserves that they want to hold, and bank lending is determined not by the volume of base money but by the interaction of the policy interest rate set by the central bank and the demand for credit.

Another variant of international liquidity aggregates either broad measures of the money supply or credit. If interest rates are low and the risk appetite of lenders has increased, credit may seem easy to obtain, so liquidity is sometimes used as a synonym for credit.
As a general idea this makes some sense, both domestically and internationally: if there is an expansion of bank balance sheets, this will often be associated with an expansion of economic activity. Credit is rarely a leading indicator, however, because by the time the extra credit appears in the statistics, it has already been spent and is no longer a source of potential future expenditure. It is just a debt which the borrower has to repay.

Analysing credit growth might still be useful, but adding this up for the world doesn't offer much in the way of insights - and in any case the discussion will be clearer if it avoids confusing credit with liquidity.

Even if credit is growing quickly, this isn't very helpful for policy analysis. In a deregulated financial system, central banks do not have direct control over credit. If people are borrowing too much, we should look for explanations in the cost of borrowing. For example, the low interest rates in Japan (the source of the yen carry-trade) and, until recently, the United States. Add to this the euphoric optimism that has bid risk margins down.

Central banks around the world can respond only through raising interest rates. To identify the problem as credit growth confuses cause and effect.

This is not to argue that international capital flows and linkages are unimportant. Far from it. As the world becomes more financially integrated, there is a greater need to understand the implications of the huge flows of international finance, and the outstanding balances of international debt and assets, with their differing currency of denomination.

These linkages impose new constraints on domestic policy: foreign interest rates will be an important input into setting domestic rates; foreign inflation will have a bigger domestic impact; monetary policy may work more through the exchange rate than through interest rates.

It is easier for countries to sustain current account imbalances and accumulate large external debt. Residents have new options to borrow and lend, and for some this will mean new opportunities to gear up and increase demand, giving them more rope to hang themselves. Asset prices will be set much more by international demand and supply, and this may be fickle and volatile.

Let's talk about the stance of monetary policy in terms of the policy instrument - short-term interest rates. There is no useful place in this discussion for confused notions of "international liquidity".

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