The Global Liquidity Crunch: A Shift In Global Funding Markets

Introduction- Understanding The Nature of Bank Liquidity Stress

A bank liquidity crunch is a financial situation where banks face a shortage of immediately available cash to meet daily obligations. This shortage of usable liquidity is a funding problem, creating expensive conditions for banks to roll over short-term funding. It ultimately increases pressure in repo markets. Repo markets are where banks borrow cash by pledging collateral. Liquidity stress also results in widening cross-currency basis spreads and creates unstable money-market conditions, with features such as higher short-term funding rates and widening spreads between secured and unsecured lending. Liquidity is the core condition which enables institutions to operate. For banks, whether it is settling payments, meeting withdrawal obligations, funding loans, or even maintaining confidence among depositors, liquidity is the most essential component of their model. It is important to note even solvent banks can face severe stress if there is a liquidity issue. Hence, a liquidity crunch threatens system-wide market functioning, not just individual banks. Banks rely on short-term wholesale funding to manage their daily cash needs, while holding buffers of High-Quality Liquid Assets (HQLA), such as sovereign bonds, to quickly sell or use as collateral to raise cash. There are also central bank backstops, such as the Fed's Standing Repo Facility, which acts as a source of cash when liquidity tightens. Therefore, a liquidity crunch involves the stress of all these channels at once, such as tighter repo markets, falling collateral values, and shrinking reserves.

Recently, concerns about tightening liquidity are emerging across major banking systems. Key signals such as central-bank funding, volatile short-term rates, and increased reliance on, and pressure within, collateral markets are raising questions about the stability of global liquidity conditions. After years of balance-sheet expansion, central banks have been withdrawing liquidity, and the effects of that withdrawal are now being felt across funding markets. Rather than it being a credit shock often seen in event-driven scenarios, liquidity pressures are emerging without a credit shock, indicating this may reflect a more structural shift. Recent policy signals, such as in the US, have calmed immediate funding pressures, but the speed with which confidence shifts around liquidity pressures illustrates the sensitivity of the system to central-bank communication. These developments are raising questions not only about what is driving a liquidity crunch across global banking, but also whether these pressures are simply cyclical or reflect a structural shift in how liquidity flows. They also raise questions about how different counterparties will navigate the dangers of liquidity tightening as we head into 2026.

The Picture: How Global Liquidity is Tightening

Global banks have begun drawing more heavily on central-bank liquidity backstops, as short-term funding markets have tightened. In the US, towards the end of October 2025, banks tapped the Fed's Standing Repo Facility (SRF) at record levels, with daily usage reaching $50.35bn on 31st October. This trend follows a long period of quantitative tightening (QT), where the Fed's balance sheet fell from ~$9tn to just $6.6tn. However, this trend is turning. On 29th October the Fed announced it will put an end to balance sheet reduction on 1st December 2025, amid evidence of tightening money market liquidity conditions and plummeting bank reserves. Since this announcement, repo rates have begun to stabilise. Simultaneously, SOFR futures show unusually high spreads to the federal funds rate, and many regional banks are starting to indicate funding stress. Thus, despite the immediate spikes and pressures being cooled, liquidity conditions remain far from smooth.

In Europe, liquidity has been tightening steadily as the ECB is unwinding its APP (Asset Purchase Programme), its quantitative easing programme launched in 2015, and its PEPP (Pandemic Emergency Purchase Programme) during the COVID-19 pandemic, bond portfolios. According to ECB's October 2025 Economic Bulletin, excess liquidity in the euro zone has fallen by more than one-third from its 2022 peak, leaving money markets operating

with smaller reserve buffers. Short-term funding rates have grown more volatile as liquidity becomes unevenly distributed. As liquidity tightens, the ECB has made a clear signal to banks that they should become more reliant on their standard refinancing operations, rather than depending on the large pool of excess reserves, shifting back towards pre-QE framework, where banks actively bid for central-bank funds to meet their needs. In practical terms, this means funding conditions will depend more heavily on banks borrowing through the ECB's regular refinancing auctions rather than relying on excess reserves. Simultaneously, the euro area is facing rising cross-border pressures, with dollar funding for euro-area banks becoming more volatile, stressing the fact non-US banks are exposed to shifts in US money-market conditions. These developments indicate the euro-area banking system is in a tighter liquidity environment, facing increased sensitivity to domestic reserve scarcity and global dollar funding.

In both Asia and emerging markets, the effects of tighter US dollar funding is evident. The banks in these regions that rely on short-term dollar borrowing via FX swaps are facing higher costs and greater volatility. In October, the IMF warned of heightened liquidity risk in the $9.6tn FX market. Additionally, there is a notable trend of developing-country borrowers replacing dollar-denominated debt with alternative currencies.

Across these different regions, there is a consistent trend of liquidity becoming harder to access. Truly understanding why though lies in the simultaneous central bank reserve drainage since 2022. The Fed began QT in June 2022 for the first time since 2019. Soon after the BoE launched active gilt sales later that year, in an attempt to normalise post-pandemic liquidity conditions. The ECB followed suit with its own balance sheet reduction from 2023 onwards, and by late 2024, reinvestments stopped entirely. This period from 2023–2024 marks a level of synchronised QT not seen since the post-2008 financial crisis, when they previously injected liquidity. The reversal has caused reserves to fall in major currency areas, and government bond supply to have surged as fiscal deficits are rising. Banks as a result have been more reliant on private funding markets instead of central bank liquidity. Even without credit stress, this shrinking of balance sheets has positioned banks in an environment of tighter funding environment, which was the root of the pressure seen late into this year.

How Bank Liquidity Works: The Mechanics Behind the Squeeze

We first outline two dimensions of liquidity: market liquidity is the degree to which one can execute transactions at low cost and with little impact on price, while funding liquidity refers to the ease with which borrowers can attain money or credit. This is important because global banks rely heavily on short-term wholesale funding and repurchase agreement markets to maintain daily liquidity. These sources are flexible but unstable because they must be rolled over frequently, so banks hold large buffers of high-quality liquid assets (HQLA) like Treasuries and other top-rated sovereign bonds, which can be sold or pledged (market liquidity) in repo to raise cash quickly (funding liquidity). As such, the balance between short-term borrowing and HQLA holdings is central to modern liquidity management and determines how resilient banks remain under strain.

Under Basel III, the Liquidity Coverage Ratio (LCR) requires banks to hold enough HQLA to cover 30 days of projected outflows, while the Net Stable Funding Ratio (NSFR) ensures that longer-term assets are funded with more stable liabilities. These standards do limit reliance on short-term wholesale funding, but meeting ratios does not guarantee stability when market liquidity evaporates. In a broad sell-off or funding squeeze, even high-quality assets can become difficult to trade or use as collateral; prices can fall sharply, haircuts can rise, and repo lenders may become more selective. So, regulatory buffers protect against moderate stress but cannot offset systemic risk when many institutions try to raise liquidity at the same time.

Liquidity is tightening now because central banks have been reducing asset holdings, lowering aggregate reserves and leaving less cash in interbank and repo markets. As previously discussed, The Federal Reserve decided in late

2025 to stop Treasury run-off from December 1st, citing tightening money-market liquidity and elevated usage of the SRF. Europe shows the same pattern in the ECB's balance-sheet normalisation and repayment of pandemic-era targeted longer-term refinancing operations (TLTROs), reducing excess liquidity. This means thinner cash buffers and more volatile short-term rates. Higher short-term rates pull cash from bank deposits into money-market funds and treasury bills, shrinking cheap funding and pushing banks toward wholesale markets. In the US, money-market-fund (MMF) assets have hit new records in 2025, and Fed staff have documented substitution between bank deposits and MMFs as rate differentials widen.

When funding tightens, lenders demand more or better collateral. Haircuts rise, margins increase, and particularly preferable collateral becomes scarce. An extreme case of this was the 2022 U.K. gilt crisis, in which leveraged users facing margin calls were forced to sell into falling markets. As these funding pressures build, they spill over into global dollar funding. Non-US banks fund large dollar books through short-term FX swaps; when stress lifts dollar demand or market makers have limited balance-sheet capacity, the cross-currency spread widens, making dollar funding more expensive and feeding directly into loan pricing and risk appetite. This creates a feedback loop: draining reserves and deposit outflows push banks toward more wholesale funding; higher demand meets tighter repo capacity; selling HQLA widens yields and worsens market depth; the cross-currency basis widens; and the stress feeds back into higher funding costs and deleveraging.

Structural Drivers: Why This Liquidity Squeeze Is Global

Over the last three years, the Fed, ECB and BoE have all been engaging in quantitative tightening, shrinking their balance sheets at the same time. The Fed has taken its assets down from roughly 9tn to 6.6tn dollars since 2022, euro-area excess liquidity has fallen by more than a third from its peak and dropped below 3tn euros, and in the UK the BoE has reduced gilt holdings from over 40% of GDP to below 25%. While individually manageable, collectively these programmes remove a large pool of reserves all at once and push banks toward private funding markets simultaneously.

Moreover, high fiscal deficits have made sovereign bond markets a constant supply machine. In the US, heavy bill and note issuance has strained dealer balance sheets and pushed bill yields above overnight index swap (OIS), showing the premium investors are demanding for warehousing collateral. The Fed's move to reinvest maturing mortgage-backed securities into Treasury bills is partly a response, redistributing demand back towards the shortest maturities. Similarly, in the euro area, governments are set to issue ~€660bn of net debt in 2025 as the ECB stops reinvestments. The UK faces a similar story. This large sovereign issuance combined with dwindling central-bank reinvestment raises term premia and increases the volume of securities to be financed in repo, pushing up short-term funding costs and inevitably putting market plumbing under tension.

US money markets show these forces clearly. At the end of October 2025, banks borrowed a record $50.35bn from the SRF in a single day, and usage over two days reached pandemic-era highs. Fed officials decided to halt quantitative tightening because reserves have fallen close to the lower bound of "ample" conditions and repo rates have become firm. On the funding-liquidity side, MMF assets have climbed to about $7.5tn, reflecting a shift of deposits out of the banking system. Large banks look comfortable in aggregate, but reserves are less plentiful, banks are leaning on backstops, and small shifts in cash around month-end push them into the SRF. In the euro area, liquidity has been draining steadily, as previously mentioned, so much so that the ECB wants banks to treat standard refinancing operations as routine funding. Repo markets show mild tightening: repo volumes have slipped, collateral shortages appear more often around quarter-ends, and general-collateral spreads are jumpier. Nothing looks dysfunctional, but the market is adjusting to less spare liquidity. In Asia, banks and currency markets are under similar pressure. In response, the People's Bank of China injected ¥400bn via six-month reverse repos in June 2025 to ease bond-market and interbank stress. The Reserve Bank of India is facing a decline in system

liquidity as well, as banks' daily surplus plunged, and the RBI convened banks and dealers in November 2025 amid concerns about funding strain in government-bond markets. Together, these developments show that the drivers behind liquidity stress are no longer confined to any one region but are taking their toll across major markets at the same time.

Policy Response and Market Implications: Navigating the Crunch

At this stage, the key challenge for major central banks, notably the Federal Reserve and the European Central Bank, is balancing inflation-control policy with funding and liquidity stability. The Fed has announced that it will end its balance-sheet draw-down (quantitative tightening) on 1 December 2025, recognising this shift. Simultaneously, the Fed's recent spike in use of its Standing Repo Facility, with $50.35bn borrowed on 31st October alone, signals that banks are already feeling a strain in short-term cash funding. Central banks therefore find themselves in a policy conundrum. Continuing tightening would risk exacerbating funding stress; however, halting it invites criticism for loosening monetary control or reintroducing excess liquidity. We see this in the US, where the Fed's quantitative tightening and reduced balance sheet shrink the safety cushion for banks, but this is being partly offset by an injection of $125bn into the banking system, its largest short-term liquidity move since the COVID crisis.

Global co-ordination and spill-over effects have become increasingly relevant. The IMF has issued warnings to banks and supervisors about liquidity risk in major currencies, most notably the US dollar, and urged enhanced FX-liquidity stress-testing and stronger global central-bank swap lines. In Europe, regulators are increasingly flagging bank reliance on US-dollar funding via FX swaps and significant currency mismatches in stable-funding requirements. As a result, existing regulatory frameworks are under review. The Bank for International Settlements has published a policy brief urging that banks' minimum liquidity requirements be recalibrated to recognise that central-bank facilities form a second defence, not just self-insurance.

These pressures carry important implications for the market. Rising short-term funding costs are emerging as banks rely more on wholesale funding and repo markets, facing a higher cost of liquidity, especially when reserves and systemic buffers are shrinking. As funding becomes pricier and banks hoard liquidity or are forced to hold more high-quality liquid assets instead of lending, there is likely a drag on bank credit growth. High-quality assets such as Treasuries and Gilts remain liquid, but during market stress their value as collateral can fall and lenders may demand larger haircuts, which weakens banks' liquidity buffers and forces them to sell assets or turn to central-bank lending facilities sooner than planned.

Market-making and liquidity provision are affected as reserves shrink and funding tightens. Banks and dealers have less capacity to intermediate trades, reducing market depth, widening bid-ask spreads, and making price discovery more volatile. Large government borrowing, especially through short-term bonds, adds pressure when funding is tight, which can widen sovereign spreads and induce volatility in repo markets with steeper haircuts. If central banks inject liquidity or ease funding conditions, investors may shift towards riskier assets in search of higher returns, and historically such periods of easy money have boosted markets like equities and cryptocurrencies, which tend to benefit from improved risk appetite and excess cash in the system.

Systematic risks can arise when these pressures accumulate. When both funding liquidity and market liquidity come under pressure, banks can face run-type stress, struggling to raise funds just as their assets become harder to sell. Many non-US banks and financial institutions rely on borrowing dollars through FX swaps or forwards, and when liquidity tightens in US money or repo markets the cost of these swaps rises, making dollar funding more expensive worldwide. Because the FX-swap market is vast (~$97tn), stress in US funding markets can quickly spread across borders, tightening financial conditions globally. If banks expect central-bank intervention during market stress,

they may keep smaller liquidity buffers and rely more on emergency support, creating moral hazard and making the system more fragile during funding pressures as less cash is held for self-insurance.

The Next Phase of The Liquidity Cycle

Liquidity dynamics are set to become the dominant driver of market conditions through 2026. The following three scenarios outline how the delicate balance between policy restraint and financial stability could unfold, from a smooth normalisation to a possible global shock.

In the **baseline scenario**, policy adjustments achieve a soft landing for liquidity conditions. The Fed's guidance in late October signalled QT ending on 1 December 2025, placing a floor under reserves and helping subdue money-market rates after a record repo-facility draw at month-end. In this case, repo-facility usage normalises, general-collateral repo trades closer to policy rates, and short-term funding spreads narrow as banks' reserves stop falling. The key mechanism used by the Fed is halting runoff, thus removing a steady drain on bank cash and easing the scramble for dollars that had been lifting repo and other short-tenor rates.

In the **adverse scenario**, the Fed's liquidity relief may prove short-lived if the supply of US Treasury bills and coupons stays high, continuing to absorb cash from the banking system even with QT paused. That keeps repo volumes elevated, widens haircuts at the margin, and encourages banks and dealers to hoard liquidity rather than lend, slowing bank credit growth. Similar dynamics may persist in Europe as the BoE continues shrinking its balance sheet and warns of "bumps in the road," while the ECB's gradual QT and expiry of its TLTRO loans drain cash from banks. Going forward, we should watch for repo rates staying above policy rates and higher repo-facility usage around month-end and settlement periods, which are both key signs of underlying funding stress.

The **crisis scenario** reflects a severe case in which global funding markets may seize up and demand coordinated intervention. If dollar funding tightens sharply, for example through a surge in the cost of FX swaps (known as a widening of the cross-currency basis), then non-US banks that depend on these swaps to roll over short-term dollar debt will face much higher refinancing costs. This pressure can quickly spread through repo markets and central-bank swap lines, forcing coordinated action such as expanded dollar-liquidity facilities or large-scale funding operations. The triggers for such an outcome are shrinking reserves, heavy government-debt issuance, and risk-off market moves that drive investors to safer assets, all of which would increase dollar-hedging costs in the enormous FX-swap market, which handles about $9-10tn in transactions daily.

In summary, October's surge in repo-facility usage and the Fed's quick announcement to end QT highlighted how policy-sensitive liquidity conditions have become. The downside to this is fragility, as confidence in day-to-day refinancing rests heavily on credible central-bank backstops and clear frameworks around liquidity, including flexible lending facilities and ready swap lines. Banks and markets are operating with thinner buffers and less room for error, meaning policy communication itself can now act as a stabilising tool.

To keep up with developments in this space, several key indicators warrant close attention. It is important to track weekly reserve data, usage of the Fed's Standing Repo Facility, and flows into or out of the Overnight Reverse Repo Facility, especially around month- or quarter-end. The spread between general-collateral repo rates and policy rates, as well as Treasury-bill issuance and settlement dates that can temporarily absorb liquidity, also

matter. Monitoring the cross-currency basis for EUR/USD, JPY/USD, and GBP/USD can reveal rising costs for global banks borrowing dollars through FX swaps. The BoE's QT pace and the ECB's collateral policies and liquidity operations shape European market dynamics, while changing haircuts in repo markets, short-term bank-funding spreads, and sovereign short-term issuance volumes can strain cash balances. Taken together, these indicators could determine how smoothly the global financial system transitions into 2026. With liquidity now the key variable shaping both policy and market direction, the next phase will hinge less on interest-rate adjustments and more on the credibility and agility of central banks in managing the world's financial plumbing.

Conclusion

The tightening in global liquidity is no longer a transitory by-product of monetary policy but a structural shift shaped by synchronised QT, rising sovereign issuance, and thinner reserve buffers across major banking systems. Funding markets are now more sensitive to small fluctuations in cash and collateral, with stresses in dollar funding, repo markets, and FX swaps increasingly transmitting across borders. Banks, dealers, and market participants are operating with reduced intermediation capacity, making liquidity conditions highly reactive to policy signals and shifts in confidence. As we move toward 2026, the trajectory of the liquidity cycle, will depend not just on interest-rate decisions but on the credibility, coordination, and agility of central banks in managing the world's increasingly fragile financial plumbing.

TAGS: Liquidity, Global Banking System, Macro