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Opinion Article

Role of market liquidity in economy

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DESCRIPTION

Market liquidity is a property of a market that allows an individual or corporation to swiftly acquire or sell an asset without creating a significant change in the asset's price. The trade-off between the price at which an asset may be sold and how soon it can be sold is known as liquidity. The trade-off is minor in a liquid market: one may sell fast without having to accept a much lower price. To sell rapidly in a very illiquid market, an asset must be undervalued. Money, sometimes known as cash, is the most liquid asset since it can be instantaneously swapped for goods and services at face value.

It may be sold quickly and for a low price at any moment during market hours. A liquid market is defined by the presence of ready and willing buyers and sellers at all times. It's comparable to, but not the same as, market depth, which is concerned with the trade-off between quantity sold and price at which it can be sold, rather than the liquidity trade-off between speed of sale and price at which it can be sold. If there are huge amounts of available and willing buyers and sellers, a market can be deemed both deep and liquid.

An illiquid asset is one that is difficult to sell (without a significant price decrease, and often not at all) due to uncertainty regarding its worth or the lack of a regularly traded market. Mortgage-related assets, which contributed to the subprime mortgage crisis, are instances of illiquid assets since their value was not easily determined while being backed by real estate. They had moderate liquidity before to the crisis since it was assumed that their worth was well understood. Speculators and market makers are important contributors to a market's or asset's liquidity. Individuals or organisations who aim to benefit from expected rises or drops in a market price are known as speculators. Market makers generate money by charging for quick execution, either implicitly through a bid/ask spread or formally through execution commissions. They achieve this by doing so offer the necessary funds to promote liquidity the danger of illiquidity does not just apply to individual assets; it also applies to whole portfolios. Financial institutions and asset managers are exposed to "structural" and "contingent" liquidity risk while managing portfolios. The risk involved with funding asset portfolios in the usual course of business is known as structural liquidity risk, or funding liquidity risk. Contingent liquidity risk is the risk of not being able to source additional funds or replace maturing liabilities in the event of future market turmoil. Open market operations occur when a central bank attempts to affect the liquidity (supply) of money.

Impact on asset prices

Asset pricing and projected returns are affected by market liquidity. To compensate for the increased cost of trading these assets, theory and empirical data show that investors want a larger return on assets with reduced market liquidity. That is, the higher the market liquidity of an asset with a particular cash flow, the higher the price and the lower the predicted return. Furthermore, if the asset's market-liquidity risk is larger, risk-averse investors want a higher projected return. This risk includes the asset return's vulnerability to overall market liquidity shocks, the asset's own liquidity's susceptibility to market liquidity shocks, and the impact of market return on the asset's own liquidity. The larger the liquidity risk, the higher the reward lowers the asset's price, the lower its predicted return.

A comparison of assets with and without a liquid secondary market is one example. The liquidity discount is the difference between newly issued U.S. Treasury bonds and off-the-run treasuries with the same period to maturity in terms of promised yield or expected return. Because the first purchasers are aware that other investors are less eager to acquire off-the-run treasuries, the freshly issued bonds are more expensive.

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