

# **What Do We Know About Liquidity?**

**Minsky and Beyond**

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# The many facets of liquidity

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- A property (individual and systemic)
  - Probability
  - Inter-temporal phenomenon
  - Socio-political construction
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- All this makes it very difficult to define and gauge 'liquidity' in a universal way

# Quality of assets, markets, institutions and systems

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Market liquidity – the ability to buy and sell assets quickly and in large volume without substantially affecting the asset's price.

Asset liquidity - those assets that can be converted into cash quickly without a significant loss in value.

Global liquidity – in terms of a financial asset that represents a claim on a foreigner that could be turned readily into foreign exchange.

(IMF, OECD)

# Probability

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- A computable probability of converting an instruments or portfolio into a means of settlement
- Stretches 'liquidity' over temporal contexts, and emphasises that market and instrument liquidity are tightly interdependent

# To the extent that

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In an unstable environment liquidity to sell  
(or to buy) virtually vanishes only to  
reappear when the market stabilises =>

‘liquidity black holes’

(Persaud 2003).

# Market liquidity comprises

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Spatial, inter-temporal, cognitive and social processes of risk evaluations.

Standardisation of products and techniques is central to creating and sustaining the market –

buyers and sellers need to share the conviction that ‘equivalent’ commodities in a flow of financial instruments are really all the same

# In a credit boom

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Liquidity was

‘the result of the appetite of investors to underwrite risk and the appetite of savers to provide leverage to investors who want to underwrite risk.

The greater the risk appetite, the greater the liquidity, and vice versa’

(McCulley 2008: 1).

# Markets are social institutions

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Market liquidity is maintained as long as collective belief in tradability of assets persists (market confidence).

Confidence depends on transparency and knowledge about new securities.

# However

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One side of liquidity is about buying

The other side of liquidity is about the ability to sell

- As securitisation became more opaque the two sides of market liquidity became difficult to synchronise at the level of the system
- New derivatives became so obscure that it could take days for a computer programme to value them, it was difficult to shift them in the markets
- More and more of these obscure products were left on balance sheets

# Inter-temporal problem

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- Liquidity in good times is not the same as liquidity in bad times
- Instability reveals the problem of diversity (vs. homogeneity)
- One paradox of liquidity: it requires common knowledge and standardisation of products
- But also relies on a diversity of views and positions in the market
- In times of stress, the diversity vanishes as investors herd and employ common valuation techniques

# Herding and financial innovation

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Usual trends of Minsky's cycle prevail:

- Underestimation of risks; expansion of new borrowings, use of quasi-legal techniques to shift the assets.
- The homogeneity of the market magnifies instability and crisis.
- Market liquidity was an artificial construction, sustained by calculative practices, political regimes and market structure.

# The political discourse of the boom

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‘represented the markets as efficient... and liquid. Such representations of finance meant that a ‘liquid’ market became an object that investors increasingly regarded as a given fact, external to them.

Since the subprime industry seemed to exemplify what was possible in an era of liquid finance, there was little to suggest that markets for assets named ‘liquid’ would be any different from the norm’ (Langley 2009).

# Searching for solutions: refining the concepts

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Market liquidity =  
market “depth”, or the ability to execute large transactions without influencing prices unduly;  
“tightness”, or the gap between bid and offer prices;  
“immediacy” or the speed with which transactions can be executed;  
“resilience”, or the speed with which underlying prices are restored after a disturbance.

Funding liquidity - is relevant for the ability of financial institutions to perform their intermediation functions. (‘cushions of safety’)

(Crockett 2008)

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Search liquidity - the ability to  
intermediate credit risk exposures with  
limited funding costs, use of capital and  
without having to hold the asset for too  
long

(Ogana et al 2006: 15)

# The link between funding and market liquidity

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Basel III – new capital cushions and leverage ratio

“the ratio will be calibrated to constrain the build-up of leverage in the banking sector, helping to avoid destabilizing deleveraging processes which can damage the broader financial system and the economy” (BIS)

## Political rifts

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Banks argue that for every £1 they retain on their balance sheet, £15 is lost to the economy because of banks' ability to leverage money.

UK is keen to delay Basle III (2018), banks are fighting against the new rules.

# Financial Innovation and liquidity

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(Minsky) – financial innovation stretches the frontier of liquidity (temporarily);

Various assets are characterised by varying degrees of liquidity.

# Degrees of liquidity?

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But this understanding implies that a solution lies in pricing

The limits of such a frontier, and its configuration, are determined by the politico-economic system

It is this systemic dimension of liquidity that remains most contentious in the post-crisis environment and most unresolved analytically