



Injecting liquidity into liquidity research



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ABSTRACT

In this paper, we aim to make more “liquid” our general understanding of liquidity research in finance. Our review of the relevant literature shows that it covers an extensive territory. Indeed, not only is liquidity important to the very existence and viability of markets, but it is also critical to the pricing of assets, the macro economy, funds management and corporate finance.

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1. Introduction

This paper reviews the finance literature on liquidity, with the key aim of making the current state of knowledge surrounding this broad topic more accessible and, thus, more “liquid” – particularly to novice researchers looking for key pointers in this rich

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area of endeavour. We begin by defining liquidity, according to its main variants and then go on to deal with the concept at various levels. Specifically, these alternative academic perspectives are: (a) macro level; (b) corporate finance; (c) asset pricing; (d) market microstructure; and, (e) managed funds. Our review incorporates the broad international literature including studies that focus on the Asia-Pacific markets.

For the purposes of our paper, liquidity has two broad meanings – “macro” versus “micro” liquidity. On the one hand, “macro” liquidity refers to the store of liquidity; for example, the level of short-term bonds in the market (Holmstrom and Tirole, 1998). On the other hand, “micro” liquidity refers to the ease with which an asset can be bought or sold and is often reflected through the bid-ask spread (Fleming, 2003). Both micro and macro liquidity are endogenously determined. Markets need macro liquidity to ensure growth, for development and stability. The macro liquidity variant is particularly important in the event of an aggregate market shock, such as a financial crisis. Put simply, if there is no micro liquidity, markets will fail. The crucial role of liquidity traders for the meaningful existence of markets is recognized in the work of Akerlof (1970) in terms of the often cited “market for lemons” concept and also in Kyle (1985).

A liquid market, in the macro sense, provides a supply (or store) of securities sufficient to meet demand. Hence, in this sense, liquidity represents an “insurance” against market shocks (Holmstrom and Tirole, 1998) that may cover either idiosyncratic shocks or aggregate shocks. The private sector might be expected to absorb the idiosyncratic shocks; however, the market may not be able to deal with aggregate shocks (Holmstrom and Tirole, 1998). In cases where firms are liquidity-constrained, their ability to borrow against future cash flows is restricted or even prevented. If there is a higher level of government securities in the market, then other things being equal, the private sector has more flexibility in responding to volatility in income and spending opportunities. This flexibility can improve economic efficiency (Holmstrom and Tirole, 1998 and Woodford, 1990).

A liquid market, in the micro sense, allows transactions to be quickly executed with negligible price impact (Borio, 2000). Lippman and McCall (1986) embed the process of selling an asset in a search environment and define liquidity as the expected time until the asset is sold, while pursuing an optimal policy (in the sense of maximization of expected discounted net proceeds). Hence, we can identify the key dimensions of micro liquidity as the familiar dimensions: cost, depth, breadth and resilience. Cost refers to the expense incurred when executing a trade. Liquid markets are those where trades can occur at a low cost (Fleming, 2003). Depth refers to the market’s capacity to absorb a temporary imbalance between demand and supply without any significant price change. High liquidity in terms of breadth means that there are a large number of market participants buying and selling the asset. A resilient market is one that is able to absorb unusually large trades – the more resilient the more liquid is the market. These dimensions of micro-liquidity are typically measured using: bid-ask spread, trade size, quote size, Kyle’s lambda, trade frequency, trade volume and liquidity spread¹ (Fleming, 2003).

In the context of liquidity research in finance, the concepts of micro and macro liquidity are not mutually exclusive and the impact of liquidity on firms and markets cannot always be cleanly dichotomized. Nevertheless, we find these alternative characterizations of liquidity very helpful guiding core elements within our review. The remainder of the paper proceeds as follows. Section 2 reviews the literature on macro liquidity. Section 3 examines liquidity concepts in the corporate sector. Section 4 examines liquidity and asset pricing. Section 5 discusses the measures of micro liquidity and reviews market microstructure research. Section 6 examines the importance of liquidity to portfolio managers.² The paper ends with some closing comments in Section 7.

2. Macro liquidity

If we apply the Arrow-Debreu model of general equilibrium, there is no special role for liquidity. Instead firms can create liquidity by either issuing new securities, borrowing from financial institutions; or holding claims on other firms. However, if the assumptions of the model are relaxed to be more realistic – e.g. allowing moral hazard and aggregate liquidity shocks, then it is no longer possible for firms to meet all of their liquidity demands (Holmstrom and Tirole, 1998). This scenario provides a need for government securities and a role for the government in actively managing the supply of these securities, subject to the market state. Where government securities are issued ex-ante and are ongoing; firms are able to establish a liquidity buffer through investment in the securities. Importantly, should there be an aggregate liquidity shock the firms have a buffer and avoid the need to liquidate positive net present value projects. The government can manage liquidity to ensure the value of government securities is high when there is aggregate uncertainty and low when there is no uncertainty. In a pareto optimal world, firms will be prepared to pay a premium for the securities. If there is a liquidity shock, firms need to be able to liquidate their government security holdings.

In the event of a financial crisis we might see a ‘flight-to-quality’ where investors rebalance their portfolios preferring less risky and more liquid securities. However, it is not clear as to whether the requirement for lower risk and/or the need for higher liquidity is driving this ‘flight-to-quality’. Interestingly, Beber et al. (2009) show that in times of market stress investors chase liquidity rather than credit quality.

¹ Further liquidity measures will be discussed in Section 5, Market Microstructure.

² We recognize that the areas covered herein are not exhaustive. To illustrate, we offer three examples below. First, there is an interesting pocket of literature that examines the linkage between liquidity and innovation (e.g. Fang et al., 2014). Second, there is liquidity and banking – though we do include one lone representative in this space, Jung and Kim (2015), in the context of macro liquidity (Section 2). Third, there is the emerging literature that looks into the inter-related nature of asset liquidity versus equity and debt liquidity (e.g. Gopalan et al., 2012).

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