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PRESS RELEASE

Self-fulfilling liquidity dry-ups

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Liquidity can be understood as the ability to transform long-term assets into current consumption goods. In that sense, secondary markets play a crucial role in liquidity provision. However, we know from Akerlof's seminal paper on secondary markets that asymmetry of information may prevent such markets to work properly. Akerlof assumes that the true quality of a second-hand car is only known by the owner. In that case, the market price depends on the average quality of the cars that are on sale. The problem comes from the fact that average quality also depends on the expected price. Clearly, if the price is anticipated to be low, owners of good quality cars will not be willing to sell and average quality will indeed be low. This phenomenon, which is called adverse selection, may lead to complete market breakdown.

This paper applies this idea to financial markets and presents a model in which the fear of a market breakdown due to adverse selection might induce investors to adopt behaviors that would actually cause such a breakdown. In that case, it becomes extremely costly to transform long-term assets into current consumption goods, which is the rationale for calling such an episode a self-fulfilling liquidity dry-up.

If investors anticipate that high market liquidity will render cash hoarding wasteful, they fully invest in the long-term assets. Consequently, any resource they consume before these assets pay off should have been planned to come from liquidation on the secondary market. This implies that all investors rely on secondary markets and it leads to a relatively high proportion of good assets in the market; liquidity is thus indeed high. However, if investors believe the market will become illiquid -that liquidation will hurt- they choose to self-insure. Therefore, they optimally decide to hoard cash. Optimal self-insurance should naturally prevent liquidation in the states of nature in which the opportunity cost is the highest. Accordingly, the agents with the best assets will not participate in the market. As liquidity decreases with average quality, this can account for equilibrium where illiquidity is a self-fulfilling prophecy.

As the market may fail to allocate resources efficiently, expectations about market liquidity have a crucial impact on welfare. Because the Government can prevent the underlying coordination failure, the model has policy implications. Potential welfare losses may indeed arise if the law-maker overlooks the "liquidity expectation channel" when considering public intervention in the case of financial crisis.