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PRESS RELEASE

Market liquidity, financing liquidity and TED spread: A two-regime model
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A secondary share market is liquid if investors can easily effect large transactions without triggering substantial price changes. This market liquidity is often measured by the ‘bid-ask spread’, the difference between the price at which one can sell (‘*ask price*’) and the price at which one can buy (‘*bid price*’). This spread is generally narrow, largely as a result of the activity of arbitrageurs who try to capitalise on temporary deviations from fundamental prices. However, the degree to which arbitrageurs can implement their strategy and thus promote market liquidity depends on how readily they can raise finance. The ease with which arbitrageurs can use their share positions as collateral to raise finance is known as financing liquidity.

Various financial and economic theories predict the possibility of an interaction between financing liquidity and market liquidity which may have a stabilising or a destabilising effect depending on the lenders’ confidence in the arbitrageurs. A stabilising interaction occurs if the financiers see the illiquidity of the market as an earning opportunity for the arbitrageurs, and provide them with more funds in order to make the market more liquid. If the market then becomes more liquid, the financiers gain further confidence in the underlying collateral, and will be all the more willing to lend to the arbitrageurs. A destabilising interaction occurs if, owing to the highly illiquid character of the markets, the financiers have less confidence in the collateral and are therefore less willing to lend to the arbitrageurs, so that the latter are less able to create liquidity in the markets.

This empirical study into the interaction between market liquidity and financing liquidity is the first to take account of the fact that both regimes (the stabilising and the destabilising interaction) may occur during the period examined. It does so by developing a two-regime model with the TED spread as the underlying confidence variable generating changes between the two regimes. The estimation method takes account of endogeneity between the two forms of liquidity.

The econometric model is applied to the American stock market between July 2006 and May 2011. We mainly find evidence of a stabilising interaction between market liquidity and financing liquidity if the TED spread is lower than 48 basis points, and we see this stabilising effect fade away if the TED spread exceeds this critical value. The TED spread is therefore a significant barometer of confidence in the financial markets and of how that confidence influences the relationship between key financial variables such as market liquidity and financing liquidity.

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