BEHAVIORAL FINANCE

When Everyone Runs for the Exit

January 1, 2009

The severe consequences for the global economy brought about by the 2008 liquidity crisis highlight the importance of liquidity risk.

Liquidity shocks are sudden, spill over across markets where levered traders have positions, and affect mostly risky and illiquid securities with large increases in margins. Liquidity events can happen even in the most liquid markets in the world, as was clearly illustrated by the sharp drop and rebound in the values of quant positions in U.S. large-cap stocks during August 2007.

While predicting liquidity crises in advance is very challenging, it is useful to understand whether price drops that already occurred were due to liquidity or fundamentals. This is because liquidity events present both risks and opportunities — liquidity-induced price drops tend to revert, and investors with dry powder can try to capture this rebound.

During a liquidity crisis, central banks can use unconventional monetary tools that improve the financing environment — e.g., by offering collateralized loans at lower (but still prudent) haircuts or margins. Even in good times, central banks need to reduce banks' incentive to take on systemic risk by restricting reliance on funding that cannot be depended on during crises, or by limiting how large and levered positions investors takes. Even better, leveraged players themselves should be encouraged to limit how large an aggregate position they take relative to their capital.

eliminate the risk of experiencing investment losses.

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