LIQUIDITY

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In business, economics or investment, market liquidity is an asset ability to be sold without causing a significant movement in the price and with minimum loss of value. Money, or cash in hand, is the most liquid asset, and can be used immediately to perform economic actions like buying, selling, or paying debt, meeting immediate wants and needs. An act of exchange of a less liquid asset with a more liquid asset is called liquidation. Liquidity also refers to a business ability to meet its payment obligations.

A liquid asset has some or all of the following features. It can be sold rapidly, with minimal loss of value, any time within market hours. The essential characteristic of a liquid market is that there are ready and willing buyers and sellers at all times. Another definition of liquidity is the probability that the next trade is executed at a price equal to the last one.

An illiquid asset is an asset which is not readily saleable due to uncertainty about its value or the lack of a market in which it is regularly traded. The mortgage-related assets which resulted in the mortgage crisis are examples of illiquid assets, as their value is not readily determinable despite being secured by real property.

The liquidity of a product can be measured as how often it is bought and sold; this is known as volume. Often investments in liquid markets such as the stock market or futures markets are considered to be more liquid than investments such as real estate, based on their ability to be converted quickly. Some assets with liquid secondary markets may be more advantageous to own, so buyers are willing to pay a higher price for the asset than for comparable assets without a liquid secondary market.

In banking liquidity is similar to liquidity of enterprises or in stock market. It means the ability to meet obligations when they come without unacceptable losses. Managing liquidity is a daily process requiring bankers to monitor and project cash flows to ensure adequate liquidity is maintained. Maintaining a balance between short-term assets and short-term liabilities is critical. For an individual bank, clients' deposits are its primary liabilities (in the sense that the bank is meant to give back all client deposits on demand), whereas reserves and loans are its primary assets (in the sense that these loans are owed to the bank, not by the bank). The investment portfolio represents a smaller portion of assets, and serves as the primary source of liquidity. Investment securities can be liquidated to satisfy deposit withdrawals and increased loan demand. Banks have several additional options for generating liquidity, such as selling loans, borrowing from other banks, borrowing from a central bank and raising additional capital. In a worst case scenario, depositors may demand their funds when the bank is unable to generate adequate cash without substantial financial losses.

Banks can generally maintain as much liquidity as desired because bank deposits are insured by governments in most developed countries. Commercial banks differ widely in how they manage liquidity. A small bank derives its funds primarily from customer deposits, normally a fairly stable source in the aggregate. Its assets are mostly loans to small firms and households, and it usually has more deposits than it can find creditworthy borrowers for. The holding of assets that can readily be turned into cash when needed, is known as asset management banking.

In contrast, large banks generally lack sufficient deposits to fund their main business – dealing with large companies, governments, other financial institutions, and wealthy individuals. Most borrow the funds they need from other major lenders in the form of short term liabilities which must be continually rolled over. This is known as liability management, a much riskier method than asset management. A small bank will lose potential income if gets its asset management wrong. A large bank that gets its liability management wrong may fail.