“Market Liquidity and Funding Liquidity”

Abstract:
We provide a model that links an asset's market liquidity --- i.e., the ease of trading it --- and traders' funding liquidity --- i.e., their availability of funds. Traders provide market liquidity and their ability to do so depends on their funding. Conversely, traders' funding, i.e., their capital and the margins they are charged, depend on the assets' market liquidity. We show that under certain conditions margins are destabilizing and market liquidity and funding liquidity are mutually reinforcing, leading to liquidity spirals. The model explains the empirically documented features that market liquidity (i) is fragile, i.e. can suddenly dry up, (ii) has commonality across securities, (iii) is related to volatility, (iv) experiences "flight to liquidity" events, and (v) comoves with the market.