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Liquidity and Financial Market Runs

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Abstract

We model a run on a financial market, in which each risk-neutral investor fears having to liquidate shares *after* a run, but *before* prices can recover back to fundamental values. To avoid having to possibly liquidate shares at the *marginal* postrun price—in which case the risk-averse market-making sector will already hold a lot of share inventory and thus be more reluctant to absorb additional shares—each investor may prefer selling today at the *average* in-run price, thereby causing the run itself. Liquidity runs and crises are not caused by liquidity shocks per se, but by the *fear of future* liquidity shocks.

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