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## Market Distress and Vanishing Liquidity: Anatomy and Policy Options

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### Abstract

Since the 1980s, a number of episodes of financial market distress have underscored the importance of the smooth functioning of markets for the stability of the financial system. At the heart of these episodes was a sudden and drastic reduction in market liquidity, characterised by disorderly adjustments in asset prices, a sharp increase in the costs of executing transactions and, in the most acute cases, a "seizing up" of markets. This essay explores the anatomy of market distress as well as the policy options to address it. It argues that, despite appearances, the genesis and dynamics of market distress resemble quite closely those of banking distress and that, contrary to conventional wisdom, the growth of markets for tradable instruments, and hence the greater scope to sell assets and raise cash, need not have reduced the likelihood of funding (liquidity) crises. At times of distress, in contrast to more normal times, risk management practices, funding constraints and counterparty risk become critical determinants of market liquidity. Articulating an appropriate policy response calls for an approach that takes full account of the interdependencies between the behaviour of market participants and market dynamics. To date, much useful work has been done to address market distress by improving the market infrastructure and the risk management at individual financial institutions. The territory that remains largely unexplored is precisely the link between the collective actions of individual market participants and market dynamics.

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