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What is liquidity?

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WHAT DOES IT MEAN?

Liquidity refers to the ease with which assets might be bought or sold. For instance, shares of large public firms are usually highly liquid as they can be bought or sold quickly, even in large quantities, at close to prevailing market prices.

On the other hand, real estate is far less liquid as it might take months or years to find a buyer or seller and to agree on a transaction.

In financial markets, one particular measure of liquidity is the difference between the "bid" price (what a securities dealer pays when you want to sell) and the "ask" price (what the dealer charges when you want to buy).

This difference is known as the bid-ask spread. A liquid security has a small bid-ask spread. Some assets are illiquid most of the time but, during a "liquidity crisis", many previously liquid securities could suddenly become illiquid.

WHY IS IT IMPORTANT?

If you need cash and you own liquid assets, you can sell them easily. But if you own only illiquid securities, you might not be able to find a buyer, or sell at a very unattractive price. Investors therefore often have a preference for liquid securities.

If you own shares, a quick look at the financial news tells you what they are worth, provided there is a liquid market for them.

However, you cannot really be sure what an illiquid asset is worth until you sell it.

If a company owns many illiquid assets, there could be great uncertainty about how much the company is worth, or whether it could raise enough cash if it got into financial difficulty.

IF YOU WANT TO USE THE TERM, JUST SAY:

In times of crisis, financial markets might experience a "flight to liquidity", in which investors attempt to dump illiquid assets and replace them with liquid assets, in case they need to raise cash quickly.

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