An Empirical Analysis of the Demand and Supply of Market Liquidity

Magnus Nyboe

Supervisor: Prof. Dr. Kjell G. Nyborg

ABSTRACT

This paper looks at the relationship of interbank tightness and market uncertainty to the liquidity of stocks on the NYSE, AMEX and NASDAQ. Through market measures of effective and quoted spreads, it documents the effect of liquidity pull-back and portfolio rebalancing as put forth in Nyborg and Östberg (2014). Increased interbank tightness leads to less liquid markets, suggesting that liquidity pull-back affects liquidity in financial markets. Increased market uncertainty decreases market liquidity, supporting portfolio rebalancing and inventory risk. Consistent with liquidity risk, the change in stock liquidity in responds to market uncertainty and interbank tightness is larger for illiquid stocks.