THE IMPLICATIONS OF LIQUIDITY CRISES IN THE CONTEXT OF EMERGING CAPITAL MARKET

Felicia Ramona Birău Ph.D Student*
University of Craiova
Faculty of Economics and Business Administration
Craiova, Romania

Abstract : This article aims to highlight the implications of liquidity crises in the context of emerging capital market. Capital markets, and especially emerging capital market appear to behave notably differently during periods of liquidity crises in comparison with periods of stability. The concept of emerging capital market itself is in obvious antithesis to the idea of financial equilibrium. This particular category of capital markets is characterized in a certain measure by profound institutional, structural and functional disequilibrium. In addition, this article aims to analyze the efficient market hypothesis in terms of liquidity. It has been empirically demonstrated that emerging capital market are rarely efficient, or in the most optimistic case weak form efficient.

JEL Classifications : G10, G12, G14, G17

Key words : liquidity, crises, disequilibrium, emerging capital market, efficiency, investors, risk

1. INTRODUCTION

The concept of liquidity is characterized by a sharp resonance in the context of emerging capital markets. This particular typology of capital markets is distinguished by certain characteristics such as : high volatility, the existence of bubbles, panic, speculation, anomalies, high-risk investment opportunities, high returns, a low level of liquidity, reduced capitalization, diversification benefits for investors in developed markets, strong correlation with developed capital markets, reduced number of transactions, insufficient development of financial instruments, exchange rate instability and many others also [Birău, 2011b]. Other areas with boundaries of development are fiscal discipline and price stability.

A detailed analysis of the history of financial crises suggested that the majority of them were triggered due to the lack of liquidity. Thus, a low level of liquidity represents a major factor of risk.

An elementary and prosaic definition of liquidity is : the probability that a particular asset can be converted into an expected amount of value within an expected amount of time.

*ACKNOWLEDGEMENT - This work was supported by the strategic grant POSDRU/CPP107 /DMI1.5/S/78421, Project ID 78421 (2010), co-financed by the European Social Fund – Investing in People, within the Sectoral Operational Programme Human Resources Development 2007 – 2013

Goodhart proposed the following meaning of the term “The word liquidity has so many facets that is often counter-productive to use it without further and closer defnition”.

According to some sophisticated approach : Liquidity is the lifeblood of financial markets. Its adequate provision is critical for the smooth operation of an economy. Its sudden erosion in even a single market segment or in an individual instrument can stimulate disruptions that are transmitted through increasingly interdependent and interconnected financial markets worldwide. [Fernandez, 1999].

From a certain point of view, the concept of liquidity is a panacea for capital markets. Thus, an optimal level of liquidity ensures market equilibrium and even efficient market condition. If the emerging capital market is apparently stable then the financial assets price can be considered approximately “fair”. In contrast, low levels of liquidity cause severe financial imbalances. Proverbial instability of emerging capital markets is a significant risk factor for investors.

2. EMERGING CAPITAL MARKET – “A FLUID CONCEPT”

In economic theory, the concept of emerging capital market presents a great number of definitions and theoretical approaches. The term "emerging market" was first used in 1981 by Antoine W. van Agtmael, an american economist who argued that an emerging market is a new economy which is in a phase of transition to a developed market.

The concept “emerging capital market” itself seems to be fluid, because it can not be limited to a simple definition, theoretical approach or geographic area. It is simply a statement of fact… with multiple meanings and implications at all financial levels.

In economic literature, the capital market is metaphorically called "economic barometer," because it implies that it anticipated growth in the real economy. In the case of the emerging capital market, this phrase remains only an incomplete definition of an economics textbook.

In present, the notion of emergent market refers to the countries with a high volatility and who are in transition, dealing with changes in economic, political, social and demographic situation. These economies have a more robust growth to reach the level of developed countries, providing an opportunity for investors who are prepared to assume additional risk to get higher yields. Therefore, the emerging capital markets have become increasingly more attractive to investors, foreign capital injection of funds in these countries are increasingly high. [A. Mody, 2004]

The largest emerging economies are: India, China, Russia and Brazil also known under the acronym B.R.I.C, the main countries of Eastern Europe (Poland, Czech Republic, Hungary), a number of countries in Latin America (Mexico, Argentina), in the Middle East (Turkey, Egypt) or from South Africa.

According to the Financial Times Stock Exchange (F.T.S. E) evaluation criteria there are four categories of classification of national capital markets: developed markets, advanced emerging markets, secondary emerging markets and frontier emerging markets.

Advanced emerging markets category are: Brazil, Mexico, Hungary, Poland, South Africa and Taiwan, while the secondary emerging markets include countries such as China, Russia, India, Egypt, Colombia, Czech Republic, Peru, Pakistan, Turkey, Indonesia and Thailand. Frontier emerging markets include capital markets from Romania, Bulgaria, Serbia, Tunisia, Cyprus, Estonia, Macedonia, Malta, Slovakia, Slovenia, Croatia, Bangladesh, Botswana, Kenya, Nigeria, Sri Lanka or Vietnam. The inclusion of a particular emerging capital market in one of the categories above is not permanent. This

situation can be changed by the fulfillment of certain criteria, but that involves achieving a significant progress.

3. LIQUID MARKET VERSUS EFFICIENT MARKET

Liquidity is a sine qua non condition for a capital market to be effective, in the sense that its capacity to ability to ability to manage financial flows is significantly higher during periods when the market is more liquid. Especially in the case of emerging capital market, maintaining an optimal level of liquidity is very important. In the literature, the concept of market efficiency is the cornerstone of modern finance and also represents a significant advance in the financial field.

In his paper "Random Walks in Stock Market Prices" published in 1965, Eugene Fama revealed that : "an efficient market is defined as a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants". He also concludes that in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value. Practically, in an efficient market, no investment strategy can earn excess risk-adjusted average returns, or average returns greater than are warranted for its risk [Barberis and Thaler, 2003].

Efficient Markets Hypothesis suggests that since everyone has access to the same information, it is impossible to regularly beat the market, because that stock prices are efficient, reflecting everything we know as investors. In other words, a market in which prices always "fully reflect" available information is called efficient [Birău, 2011a].

In other words, Efficient Markets Hypothesis suggests that any information is available to all investors on the market, so stock prices always incorporate and reflect all relevant information. Therefore, the price of a stock should reflect the knowledge and expectations of all investors.

According to Malkiel : "A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. Formally, the market is said to be efficient with respect to some information set…if security price would be unaffected by revealing that information to all participants. Moreover, efficiency with respect to an informational set …implies that it is impossible to make economic profits by trading on the basis of (that informational set)."

It is evident the apparent antagonistic contradiction between the concept of market efficiency and the emerging capital markets. It has been empirically demonstrated the fact that most of the efficient market research have focused on developed capital markets and it is considered in general that emerging capital markets are not efficient in semi-strong form or strong form. Moreover, very few capital markets are weak form efficient.

In another train of thoughts, a liquid market allows that a large volume of transactions to be conducted with minimum effect on price. At some point, it is crystallizes a very interesting connection between the concepts of efficiency and liquidity. Thus, the capital market liquidity contributes significantly to improve market efficiency. A high level of liquidity contributes substantially to enhancing the available information that is reflected in market prices.

Metaphorically speaking, the reverse of the medal is very dramatic. Destabilisation implications of the emerging capital market generated by insufficient liquidity are extremely severe. It is extremely important to distinguish between liquidity and trading

volume. There is a paradox in time of financial crisis, respectively a lower liquidity level corresponds to a high volume of transactions.

Efficient market hypothesis have not reached the issue of liquidity crisis, or even the concept of liquidity itself. It assumes that investors are rational and they aim to select certain efficient financial assets to form an optimal portfolio as to achieve the highest possible returns over the long term, under the terms of a tolerable level of risk. However, in conditions of crisis, investors have a completely irrational behavior.

According to Peters : "If all information had the same impact on all investors, there would be no liquidity. When they received information, all investors would be executing the same trade, trying to get the same price."

It is significant to highlight the fact that investment decision is influenced in a large proportion by psychological and emotional factors. Human emotional complexity includes the following primary feelings: fear, panic, anxiety, envy, euphoria, greed, satisfaction, ambition or vanity. This cocktail of human emotions interferes in certain proportions in a financial investment decision making. Investors are people with many deviations from rational behavior, which often make illogical decisions. In the existing global financial perspective, the major influence of psychological factors in investment decision-making is undeniable [Birău, 2011a].

Accordingly, chances that an investor to behave rationally in liquidity crisis conditions are extremely low. In such circumstances, obtaining a fair price is no longer a priority.

4. CONCLUSIONS

Liquidity crises are a consequence of inadequate capital market functioning. In terms of emerging capital market it highlights the fact that they are characterized by severe institutional, structural and functional disequilibrium.

The vulnerability of emerging capital markets and its high degree of exposure to liquidity crises can be reduced by implementing some rigorous measures, such as : the adoption of relevant legislation, securities laws and regulations, the improvement of the trading infrastructure system, the establishment of appropriate supervisory structures, promoting transparency and fairness, discouraging short-term speculation in favor of long-term investments.

REFERENCES

1.	Aguiar, M. Gita, G.	Emerging Market Business Cycles: The Cycle is the Trend, Journal of Political Economy,vol.115, nr.1, 2007
2.	Aizenman, J.	Emerging markets, Santa Cruz, 2005 http://www2.ucsc.edu/econ /faculty/ aizenman/Emerging_Markets.pdf
3.	Aizenman,J., Powell, A.	Volatility and Financial Intermediation, Journal of International Money and Finance, 2003, vol.22 (5)
4.	Birău, F.R.	Behavioral Finance Paradigm And Its Implications On Investment Decisions, International Scientific Conference „ECO-TREND 2011 - Exit From The Crisis And Revival Of Sustainable Growth", 8th edition, November 25-26, 2011, Tg – Jiu, Romania
5.	Birău, F.R.	The meanings of efficient market paradigm in the context of emerging capital markets. An analysis of weak-form efficiency on the Bucharest Stock Exchange, The International Conference,

„Competitiveness And Stability In The Knowledge Based Economy", The Faculty of Economics and Business Administration, University of Craiova, Romania, 4 - 5 November 2011

6. Chang,R. Velasco, A. — Liquidity Crises in Emerging Markets: Theory and Policy, Federal Reserve Bank of Atlanta, Working Paper 99
7. Eichengreen,B., Mody, A — What explains changing spreads on emerging-market debt : fundamentals or market sentiment?, National Bureau Of Economic Research, Cambridge, 1998 http://www.nber.org/papers/w6408
8. Fama, E. — Random Walks in Stock Market Prices, Financial Analysts Journal , 1965
9. Fama, E. — Market effciency, long-term returns, and behavioral finance, Journal of Financial Economics 49, 1998, pp.283-306
10. Fernandez, A. — Liquidity Risk - New Approaches To Measurement And Monitoring, Securities Industry Association, December 1999
11. Goodhart, C. — Liquidity risk management, Financial Stability Re-view, Banque de France, February 2008
12. Jensen, M. — Some anomalous evidence regarding market efficiency, Journal of Financial Economics, vol. 6, 1978, pp. 95– 101
13. Houthakker,H. Williamson, P. — The Economics of Financial Markets, Oxford University Press, Inc., New-York, 1996
14. Jensen, M. — Some anomalous evidence regarding market efficiency, Journal of Financial Economics, vol. 6, 1978, pg. 95– 101
15. Malkiel, B. — The Efficient Market Hypothesis and Its Critics, Princeton University, CEPS Working Paper No. 91, 2003
16. Malkiel, B — Efficient market hypothesis", New Palgrave Dictionary of Money and Finance. London: Macmillan, 1992
17. Malkiel, B. — A Random Walk Down Wall Street, W.W.Norton &Company, Inc., New-York, U.S.A, 1973
18. Samuelson, P. — Proof That Properly Anticipated Prices Fluctuate Randomly, Industrial Management Review, 1965, pg.41-49
19. Sewel, M. — History of the Efficient Market Hypothesis, Research Note RN/11/04, 2011
20. Timmermann,A. Granger, C. — Efficient market hypothesis and forecasting, International Journal of Forecasting, 2004, pg. 15– 27