Chapter 16

A Comparative Analysis of Drivers of Secondary Market Liquidity in Financial Markets for Investment Analysis: Evidence From Turkey

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ABSTRACT

The purpose of this chapter is to examine the drivers of secondary bond market and stock market liquidity for investment analysis after global financial crisis in Turkey. The literature in Turkey mainly focuses only on the volatility of return for driving liquidity in both bond and stock markets. However, it is argued that other types of volatilities including domestic and international volatilities have also a deteriorating impact on secondary market liquidity in Turkey. In this context, it is empirically tested whether the volatility and/or uncertainty that stem from the FED and ECB policies within the last 10 years had a negative impact on liquidity both in government bond and stock markets. Moreover, the impact of non-residents in bond and stock markets on secondary market liquidity is examined by including their holdings in stock and bond market.

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INTRODUCTION

A significant number of researches reveal that there is a close correlation between economic development and financial development (Gelb, 1989; Ghani, 1992; King & Levine, 1993; Levine, 1995; DeGregorio & Giudotti, 1995; Demirguc Kunt et al., 2004; Levine & Zervos, 1996). One of the indicators of the development of financial sector is its liquidity. However, providing a rigorous and empirically relevant definition of liquidity is a difficult task. This difficulty arises from different reasons. First of all, there is no one single type of liquidity and often different types of liquidities are confused. Second, liquidity has different dimensions and hence a single liquidity measure may not be able to capture all of these different dimensions. Third, although liquidity can be considered as a public good, meaning that each financial actor benefits from the availability of it although they do not voluntarily contribute to it. Another complicating factor is that issuers of assets, policy makers or financial institutions investing in these assets have different perspectives on liquidity.

Liquidity is a complex concept with several different dimensions such as market liquidity vs. funding liquidity, micro liquidity vs. macro liquidity and endogenous liquidity vs. exogenous liquidity. These difficulties make it hard to define liquidity and to measure it in a straightforward way. Hence, different proxies are used to measure it. There are three types of liquidity often confused with each other. In this study, the aim is to talk about the liquidity of a financial asset. This type of liquidity is called market liquidity. It is defined as the ability to rapidly execute sizeable transactions at a low cost and with a limited impact on market price (IMF, 2015). The concept of market liquidity is different form the concepts of funding liquidity and monetary liquidity. Funding liquidity is the ability of market participants to obtain funding from financial markets at acceptable conditions whereas monetary liquidity is the liquidity that is provided to financial markets and to the economy through increase in monetary aggregates by central banks and monetary authorities (IMF, 2015). Although all these concepts are different from each other, there are close relations among them. First, funding liquidity is usually a prerequisite for market liquidity since market makers, who are the main providers of liquidity also use credit or short term borrowing to maintain their inventories. Market liquidity tends to enhance funding liquidity because margin requirements depend on the liquidity of the securities. Increase in monetary aggregates through monetary easing (monetary expansionary policy) ease funding conditions and hence facilitate market-making activities. With the facilitation of market making activities monetary liquidity also helps to get higher market liquidity. However, one should be careful about interpreting these relations among three liquidity concepts, because they are not always one to one and other factors may also play important roles in the relations among these three liquidity concepts. After making the distinction among three types of liquidity clear, it is possible to turn to market liquidity which is the main issue of this study. According to the traditional definition of market liquidity, a market is said to be liquid if market participants can sell financial securities at the lowest cost and without having any significant impact on the market price. This definition of liquidity incorporates some important features which are worth mentioning to fully understand the concept of market liquidity. The features may be expressed as follows:

- **Tightness**: A market is said to be tight, when the spread between bid and ask prices are narrow. As the liquidity dries up in a financial market, the spread between bid and ask prices increases. Hence, this difference is also used as a proxy for the measurement of liquidity.
- **Depth**: The depth of a financial market illustrates the maximum transaction volume that can be executed without having an impact on the market price (IMF, 2004). It can be measured by the
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