



# Market Liquidity: Theory, Evidence, and Policy

By Thierry Foucault, Marco Pagano, Ailsa Röell

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**Market Liquidity: Theory, Evidence, and Policy** By Thierry Foucault, Marco Pagano, Ailsa Röell

The way in which securities are traded is very different from the idealized picture of a frictionless and self-equilibrating market offered by the typical finance textbook. *Market Liquidity* offers a more accurate and authoritative take on liquidity and price discovery. The authors start from the assumption that not everyone is present at all times simultaneously on the market, and that even the limited number of participants who are have quite diverse information about the security's fundamentals. As a result, the order flow is a complex mix of information and noise, and a consensus price only emerges gradually over time as the trading process evolves and the participants interpret the actions of other traders. Thus a security's actual transaction price may deviate from its fundamental value, as it would be assessed by a fully informed set of investors.

This book takes these deviations seriously, and explains why and how they emerge in the trading process and are eventually eliminated. The authors draw on a vast body of theoretical insights and empirical findings on security price formation that have accumulated in the last thirty years, and have come to form a well-defined field within financial economics known as "market microstructure." Focusing on liquidity and price discovery, they analyze the tension between the two, pointing out that when price-relevant information reaches the market through trading pressure rather than through a public announcement, liquidity suffers.

The book also confronts many puzzling phenomena in securities markets and uses the analytical tools and empirical methods of market microstructure to understand them. These include issues such as why liquidity changes over time, why large trades move prices up or down, and why these price changes are subsequently reversed, why we see concentration of securities trading, why some traders willingly disclose their intended trades while others hide them, and why we observe temporary deviations from arbitrage prices.

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## Editorial Review

### Review

"*Market Liquidity* by Professors Foucault, Pagano and Röell is a wonderful addition to the literature on how markets work; why, sometimes, they don't work as we might wish; and how this affects regulation and corporate decision making. The book is rich in detail, covering the institutional structure of financial markets and the economic and statistical models we use to understand them. While structured as a textbook, it can be read in different ways. Those less interested in the mathematical details will profit from the beautifully written description of the models, some of which are new, and their economic lessons."--Lawrence R. Glosten, S. Sloan Colt Professor of Banking and International Finance, Columbia University

"Ailsa, Marco and Thierry need to be commended for writing this important and timely contribution on the topic of liquidity that has not just matured over the past twenty years, but which has in fact taken a center-stage as practitioners, policy-makers and academics use liquidity of markets as a barometer for the 'healthy functioning' of economies. The book is rigorous and precise, which is useful given liquidity has many connotations. I strongly recommend the book to all interested in understanding liquidity."--Viral Acharya, C.V. Starr Professor of Economics, New York University

"This book is a highly readable introduction to market microstructure, emphasizing both practical institutional details and applications of theoretical and empirical research to the real world of trading. It is not only a useful introduction to market microstructure for practitioners but also a great textbook for students at advanced undergraduate, masters, and even Ph.D. levels. I like in particular the numerous connections the book makes between trading institutions and public policy issues."--Albert "Pete" Kyle, Charles E. Smith Chair Professor of Finance, University of Maryland

"Drawing on their broad and extensive knowledge of market microstructure, three leading teachers and researchers have written a comprehensive guide to the principles and practicalities of securities trading. *Market Liquidity* comprehensively covers the dealer and limit order markets that account for the preponderance of trading volume. It provides perspectives on these markets from the viewpoints of market operators, traders, and regulators, and connects these markets to real corporate and investment decisions. The exposition is extremely systematic, lucid and accessible. Students and practitioners alike will find this text to be current and invaluable."--Joel Hasbrouck, Kenneth G. Langone Professor of Finance and Business Administration, New York University

### About the Author

Thierry Foucault is Professor of Finance, HEC Paris International Business School.

Marco Pagano is Professor of Economics, University of Naples Federico II.

Ailsa Röell is Professor of International and Public Affairs, Columbia University.

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