

## Market liquidity: why it disappears when it is needed most

**When the market can't see how much is being bought or sold, it stops absorbing risk and can rapidly unravel. It doesn't help that Europe and the United States don't play by the same rules.**



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On May 6, 2010, the Dow Jones fell by around 9%. Within minutes, liquidity evaporated.

Prices collapsed, even though the index recovered part of its losses before the market closed that day.

Although no single event fully explains this episode, known as a “flash crash,” IESE’s [Xavier Vives](#) and Giovanni Cespa (Bayes Business School) argue that something fundamental to the functioning of the market broke down: its ability to absorb buy and sell orders when demand for liquidity suddenly surged.

In “[Market opacity and fragility: why liquidity evaporates when it is most needed](#),” published in *American Economic Review*, the authors conclude that when market participants can’t clearly observe the aggregate order flow, the resulting lack of information does more than make liquidity more expensive — it can cause illiquidity to become self-reinforcing.

## **Market opacity hurts those who most need to trade**

The absence of reliable information about order flow can seriously reduce the market’s ability to absorb risk. Under extreme conditions, this dynamic can trigger a market sell-off.

The reason lies in the interaction between different types of investors. Some enter the market because they need to hedge positions or rebalance portfolios. Others arrive later and could absorb some of that pressure if they understood the initial imbalance. But if they can’t infer what is going on, they behave more cautiously or speculate in ways that are less helpful for stabilizing the market.

This creates a form of strategic complementarity: If prices appear increasingly sensitive to incoming orders, each participant adjusts their behavior in a way that reinforces that greater price impact. Liquidity is no longer a stable feature of the market but instead depends on expectations, available information and the market’s capacity to absorb risk. This dynamic can emerge when uncertainty rises unexpectedly or when liquidity providers become more risk-averse, as happened during the COVID-19 crisis.

In such a fragile equilibrium, the investors with the greatest need to trade may ultimately bear the highest transaction costs. Liquidity ceases to act as a shock absorber and instead penalizes those who need to enter the market most urgently.

# Market efficiency increases, but the risk remains

Paradoxically, this fragility has emerged in markets that are, at least on paper, faster and more efficient than ever. The shift toward electronic trading has reduced friction and expanded trading capacity, but it has also changed who provides liquidity.

In today's electronic markets, liquidity no longer depends solely on traditional dealers. It is also supplied by algorithmic traders (computer programs that execute trades automatically) and by other market participants who are not typically considered liquidity providers. Even investors who usually consume liquidity, such as portfolio managers or hedge funds, can supply it when they have sufficient information. This flexibility can improve market performance under normal conditions, but it does not necessarily guarantee stability during periods of stress.

Unlike permanent market makers, some of these liquidity providers may scale back their activity when they struggle to interpret market conditions. Their withdrawal matters because, in modern markets, a significant share of the market's ability to absorb orders depends on them.

## The need for a consolidated tape

The U.S. has long operated a “consolidated tape” — a unified market data feed that aggregates essential information from different trading venues. In the EU and the U.K., by contrast, market participants must combine data from multiple exchanges to obtain a complete picture. Doing so requires both financial resources and technological capabilities, creating a two-tier system: Those who can afford to acquire and process the data gain a clearer view of the market, while others must trade with only a partial picture.

While policymakers in both the U.K. and the EU support the idea of a consolidated tape, stock exchanges have resisted, fearing they would lose revenue. Even so, in June 2026, [a consolidated tape went live for the U.K. bond market](#) for the first time.

Vives and Cespa argue that it's a benefit worth having. Granted, a consolidated tape alone cannot prevent episodes such as flash crashes: The U.S., for example, has experienced major market disruptions, despite having one. Still, reliable market data reduces the likelihood that liquidity stress will escalate into a full-blown market crisis.

Read more on this topic by Xavier Vives and Giovanni Cespa in a [VoxEU column](#) of the Centre for Economic Policy Research (CEPR).

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