Three Facets of Liquidity Illusion: Financial Innovation and the Credit Crunch

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This article identifies the phenomenon of liquidity illusion as the key element that has disguised the systemic fragilities which have precipitated the global credit crunch. At the core of phenomenon of liquidity illusion lies the spiral of private financial innovation and risk-trading processes underpinning it. The paper identifies three intertwined levels where liquidity illusions have led to systemic implosions: macroeconomic, market-centred, and international. Today's facets of liquidity illusion stem, just as Keynes observed some seventy years ago, from the trade-off between individual choices and perceptions of financial players, and aggregate outcomes of these actions in a wider context. The article analyses this trade-off in the context of the continuing global credit crisis.

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