



Value and liquidity under changing market conditions

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Abstract

Papers studying the liquidity of a market tend to focus on decisions involving the trade-off between the selling price and the time-till-sale for a given set of market conditions. This paper characterizes market conditions using a price-probability locus; a *change* in market conditions is some combination of changes in the level and/or slope of this locus. I show how the effect of either type of change on price and on the probability-of-sale can be decomposed into those commonly associated with an increase in the value and those which involve a substitution between price and probability. Two adding-up conditions restrict the set of possible predictions. Though the discussion focusses on real estate market, where scarcity is rationed by a mechanism which combines search and bargaining, the same ideas apply to markets with other types of selling mechanisms.

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1. Introduction

Consider the problem facing someone who has decided to sell their house. The selling price depends on the type of house, on market conditions and on luck. A seller can affect

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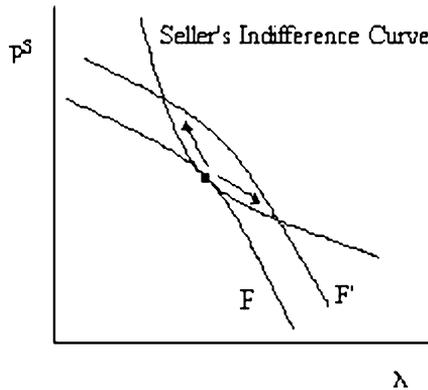


Fig. 1. The effect of a change in market conditions on the price-probability locus.

the outcome by carefully choosing the list price that is seen by potential house buyers but that choice also affects the probability of sale and the expected time-till-sale. Researchers are beginning to form a consensus on the best way to estimate the determinants of this second process,² but there has been little analysis of the trade-off per se and little analysis of the process by which an individual reacts to a change in market conditions.

This paper uses a locus of feasible combinations of the expected sale price and of the probability of sale to describe the trade off created by a given set of market conditions. Fig. 1 demonstrates that a change in market conditions has an ambiguous effect on an individual seller unless one is willing to add restrictions. A change in market conditions is usually expected to change the value of a house. A change in market conditions may change the ease of selling and, if so, it may also change the seller's selling strategy and the ultimate selling price. This paper focusses on decomposing the full effect of a change in market conditions into two parts: a level effect which mimics the effects of an increase in the value of a house and a slope effect which causes a seller to substitute between price and the probability of sale. Some adding-up conditions restrict the range of permissible outcomes and can be used to test whether observed behavior satisfies necessary conditions for optimal decision-making.

The trade off between the selling price and the probability of sale is presumed to exist in a markets because of transaction costs. Unfortunately, these costs are difficult to quantify directly and, consequently, their link to studies of a real estate market is usually weak. Some researchers, e.g. Glower et al. (1998); focus on the actions of sellers with different tastes but, with few restrictions on tastes available, few predictions were possible. By focussing on aspects of behavior which are payoff-relevant, instead of being specific to a selling mechanism, I offer general insights into the market process. An appendix shows how the parameters of sellers' objective function might, in principle, be deduced from the coefficients estimated from a common specification of two regression equations.

² See, for example, Anglin et al., 2003; Ong and Koh, 2000; Forgey et al., 1996; Springer, 1996; Kalra and Chan, 1994, and Kluger and Miller, 1990. A few papers specifically focus on liquidity: Forgey et al., 1996; Kluger and Miller, 1990.

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