Working Papers on Economics - Liquidity and Counterparty Risks Tradeoff in Money Market Networks

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We examine how liquidity is exchanged in different types of Colombian money market networks (i.e. secured, unsecured, and central bank’s repo networks). Our examination first measures and analyzes the centralization of money market networks. Afterwards, based on a simple network optimization problem between financial institutions’ mutual distances and number of connections, we examine the tradeoff between liquidity risk and counterparty risk. Empirical evidence suggests that different types of money market networks diverge in their centralization, and in how they balance counterparty risk and liquidity risk. We confirm an inverse and significant relation between counterparty risk and liquidity risk, which differs across markets in an intuitive manner. We find evidence of liquidity cross-underinsurance in secured and unsecured money markets, but they differ in their nature. Central bank’s role in mitigating liquidity risk is also supported by our results.

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