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What Is Liquidity in Crypto?

Original:
https://www.btcc.com/en-US/academy/crypto-basics/what-is-liquidity-in-crypto

Liquidity is important for all tradable assets including cryptocurrencies, which refers to the ability of a coin to be easily converted into cash or other coins.

What is a good way to measure the health of a market? You could look at trading volume, market volatility, or other technical indicators. However, there is one crucial factor – liquidity. If the market lacks liquidity, it can be quite difficult to execute trades without a significant impact on prices. Let's dive into what liquidity exactly is and why it matters.

What is liquidity in trading?

Liquidity definition

Liquidity refers to the measure of how easily you can convert an asset into cash or another asset without affecting its price. In simple terms, liquidity describes how quickly and easily an asset can be bought or sold. You may have the rarest, most valuable old book in your backpack, but if you're alone on a remote island, it will be difficult to find a buyer.

In this sense, good liquidity means that an asset can be quickly and easily bought or sold without having much effect on its price. Conversely, bad or low liquidity means that an asset can't be bought or sold quickly. Or, if it can, the transaction would have a significant effect on its price.

Cash (or cash equivalents) can be considered the most liquid asset since it can be easily converted into other assets. A similar asset in the world of cryptocurrencies is a stablecoin.

While stablecoins and digital currencies aren't part of the standard for everyday payments yet, it's only a matter of time until they are widely accepted. In any case, much of the volume in the cryptocurrency market is already done in stablecoins, making them very liquid.

On the other hand, real estate, exotic cars, or rare items may be considered relatively illiquid, since buying or selling them isn't necessarily an easy feat. You may have a rare artifact in your possession, but finding a willing buyer at what you consider to be a fair market price may be difficult.

Also, let's say you'd like to buy a car with your artifact. It'll be almost impossible to find someone selling the exact car you want who wants to exchange it for your artifact. This is where cash comes in useful.

Tangible assets are generally less liquid than digital assets due to them being… well, tangible. There are additional expenses involved, and the transaction may take a fair bit of time to complete.

However, in the context of digital exchange and cryptocurrencies, buying or selling assets is a game of moving bits around in computers. This does provide some benefits to liquidity, since clearing a transaction is relatively simple.

With that said, it might be best to think about liquidity as a spectrum. On one end, we have cash and stablecoins. On the other end, we have very illiquid assets such as rare items. It's best to think about assets as being on a certain part of this liquidity spectrum.

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Market liquidity

Market liquidity is the extent to which a market allows for assets to be bought and sold at fair prices. These are the prices that are the closest to the intrinsic value of the assets. In this case, intrinsic value means that the lowest price a seller is willing to sell at (ask) is close to the highest price a buyer is willing to buy at (bid). The difference between these two values is called the bid-ask spread.

The bid-ask spread

The bid-ask spread is the difference between the lowest ask and the highest bid. As you'd imagine, a low bid-ask spread is desirable for liquid markets. It means that the market has good liquidity since inconsistencies in price are continually brought back to balance by traders. In contrast, a large bid-ask spread usually means that a market is illiquid, and there is a large difference between where buyers want to buy and where sellers want to sell.

The bid-ask spread can also be useful for the so-called arbitrage traders. They aim to exploit small differences in the bid-ask spread over and over again. While the arbitrage traders make a profit, their activity also benefits the market. How come? Since they reduce the bid-ask spread, other traders will also get better trade execution.

Arbitrage traders also ensure that there aren't big price differences between the same market pairs on different exchanges. Have you ever noticed how the BTC price is roughly the same on the biggest, most liquid exchanges? This is largely thanks to arbitrage traders, who find small differences between prices on different exchanges and profit off of them.

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Why is crypto market liquidity so important?

So, since cryptocurrencies are digital assets, they should be quite liquid, right? Well, not quite. Some cryptoassets have vastly better liquidity than others. This is simply a byproduct of higher trading volume and market efficiency.

Some markets will only have a few thousand dollars of trading volume per day, while others will have billions. Liquidity isn't a problem for cryptocurrencies like Bitcoin or Ethereum, but many other coins face a significant lack of liquidity in their markets.

This is especially important when it comes to trading altcoins. If you build up a position in an illiquid coin, you may not be able to exit at your desired price – leaving you holding the bag. This is why it's generally a better idea to trade assets with higher liquidity.

What happens if you try to execute a large order in an illiquid market? Slippage. It's the difference between your intended price and where your trade is executed. High slippage means that your trade is executed at a very different price than what you intended. This usually happens because there aren't enough orders in the order book close to where you intended to execute them. You can circumvent this by only using limit orders, but then your orders may not fill.

Liquidity can also vastly change under different market conditions. A financial crisis can have a significant impact on liquidity as market players rush to the exit to cover their financial obligations or short-term liabilities.

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To conclude

Cryptocurrency markets are becoming more and more popular, attracting more speculators and traders with it. This growth will create a healthier environment that avoids slippage made by big traders. However, small markets will always exist, and new cryptocurrency markets will keep being created. Liquidity is an important factor when considering the financial markets.

In general, it's desirable to trade markets with high liquidity since you'll be able to enter and exit positions with relative ease. After reading this article, hopefully, you'll understand what high or low liquidity exactly is and how it affects your crypto trading.

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