The concept of financial market is limited, in the following analysis, to any market where easily resalable debt and/or equity securities of business firms and governments are traded. Financial markets, therefore, always encompass well-organised, continuous and orderly spot markets.

1 LIQUIDITY AND THE ROLE OF SPOT FINANCIAL MARKETS

Well-organised markets for financial assets are essential to the development of liquidity properties for any asset other than money. For an agent to possess liquidity one must have the ability to meet one’s contractual obligations when they come due, i.e. to be liquid means that an agent has available, or can readily obtain, the means of contractual settlement. In order to provide liquidity, therefore, any asset other than money must be readily resalable in a well-organized, continuous spot market in order to obtain the means of contractual settlement. (Money which, by definition, is the means of contractual settlement, possesses the highest degree of liquidity possible.)

A real world requirement for the existence of any well-organized spot market is a market-maker, i.e. an institution willing, and able, to act as the buyer and/or seller of last resort in the market.

A fully liquid asset is any durable whose resale market is dominated by a market-maker who (i) stands ready to buy or sell any quantity of the asset being traded at a fixed announced nominal price, and (ii) has virtually unlimited resources to maintain this market price. Fully liquid assets, therefore, can be converted into the medium of contractual settlement at the option of the holder. In modern bank-money economies, this implies that all fully liquid assets are those whose value in terms of domestic money is guaranteed via a market-maker institution which is either a division or an agent of the central bank.

A liquid asset is a durable traded in a well-organised, continuous resale market in which the market-maker is expected to intervene only to main-
tain 'orderliness' in the spot market, whenever price movements become, in the judgement of the market maker acting under the rules of the particular organized market, too volatile to be justified by the circumstances. In liquid asset spot markets, it is expected that, in normal times, the price will change by small increments over time; most of the transactions will involve bull and bear individuals, with very few transactions involving the market-maker. The latter will be required by the rules to intervene to slow price changes only when one side of the market (either the bulls or the bears) tends to dry up – with the result of disorderly, discontinuous large changes in spot market prices in the absence of deliberate market-maker actions. The existence of market-makers in liquid asset financial markets permits most market participants to expect that they can liquidate their holdings easily whenever they desire. Most financial markets trade in liquid, rather than fully liquid, assets.

Finally, an illiquid asset is any durable whose spot market is poorly organised, disorderly, and/or even notional. Most real capital goods are illiquid assets. Some debt (e.g. most consumer and some business bank loans) as well as some small business equity certificates are essentially illiquid assets.

2 FINANCE, FUNDING AND NEW INVESTMENT

Financial markets play two important roles in the economy. First, via the 'new issue' segment of the financial market, money is transferred from economic agents who currently possess some wealth in the form of the medium of contractual payment to others who desire to 'fund' investment in costly, long-lived, illiquid assets. The concept of funding involves the selling of new issues of long-term debt and/or equity securities by buyers who use these 'funds' to pay the producers of illiquid fixed capital goods immediately for delivery – thereby permitting investors to take a position in real illiquid assets (cf. Davidson, 1982, pp. 36-7). Since fixed capital goods are not expected to generate sufficient quasi-rents to pay for themselves in the current period, buyers must fund the purchase price over a long period.

If entrepreneurs, who desire to establish profitable positions in costly illiquid real fixed capital, could not be assured of obtaining funding at acceptable costs via the new issue market by underwriting institutions, then these investors would not be willing to commit themselves contractually by ordering forward the new capital goods upon which the growth of the economy depends. The underwriting commitment for future funding permits entrepreneurial investors to commit themselves contractually today for the future (date of delivery) purchase of capital goods.

The producers of capital goods, armed with these forward contractual