Comment to “Who supplies liquidity, how and when?”
by
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Let me first of all thank the organizers for the invitation to this interesting conference.

Then, before discussing this interesting paper by Bruno and colleagues, let me make two preliminary remarks.

The first, obvious but important, remark, is that a very preliminary presentation, as the one by Bruno, can only give rise to a very preliminary discussion. In the absence of a fully-fledged paper, my interpretation could be wrong or incomplete.

The second preliminary remark is about the definition of liquidity. There are at least three separate, but connected, concepts of liquidity: funding liquidity, central bank liquidity and market liquidity. Bruno´s paper is on the latter. In particular Bruno looks at the liquidity of stocks on the basis of a huge number of observations referring to 2010 data. Nowadays we are more worried about bonds rather than stocks liquidity, but looking at the latter can shed some light also on the former.

I read the interesting and intriguing analysis of Bruno and colleagues looking for answers to 6 policy questions:

1. Is the complaint of bankers justified that recent regulatory changes limiting proprietary trading have negatively affected liquidity, because intermediaries are no longer able to buffer liquidity shocks by warehousing securities?
2. Does proprietary trading have a socially valuable function?
3. Does fast trading have a socially valuable function?
4. Have there been over the last few years innovations in market organization - essentially IT developments - leading to easier matching of “natural” sellers and buyers, thus reducing the need of securities warehousing?
5. Have there been in recent years innovations in the distribution and processing of information such that adverse selection has been reduced as less weight is given to liquidity shocks because of better fundamental information?
6. Is more abundant funding liquidity, essentially because of the provision of central bank liquidity, helping market liquidity?

The paper by Bruno is very useful in shedding light on the first three of these questions.

Let me come to my understanding of what Bruno`s results have to say about them.

I think questions 1 and 2 can be answered together, following Bruno`s analysis, in the affirmative: regulation limiting proprietary trading negatively affects liquidity while proprietary trading has a positive social value.

I draw this conclusion from the following results:

Proprietary traders, belonging to both the fast and the slow category, place contrarian "take" orders, even during crisis, instead of following momentum. Their ability to do so depends on not having (or having fewer) agency problems as they act as principals, having better risk bearing capacity and suffering less adverse selection, especially when belonging to the "fast" category. And in their action they are profitable. The latter point is, if you remember, by analogy, Friedman`s conclusion that only profitable foreign exchange interventions have stabilizing properties, another indirect evidence of a socially useful function. Furthermore, in a Darwinian perspective, profitability assures the ability of proprietary traders to perform their stabilizing function in a persistent way. Obviously if not hindered by regulation.

Overall in the evidence provided by Bruno and colleagues I could not find evidence of a positive social function for fast traders as such. While fast proprietary traders share the positive characteristics of proprietary traders, there is nothing specific to fast traders that clearly identify them as socially useful. Of course, they put forward many more orders than slow traders and cancel and modify them much more frequently, but they tend to be, unless they are proprietary traders, momentum traders, thus contributing to sustained price changes. They do not appear to be, in their make orders, less exposed to adverse selection than slow traders once the distinction between proprietary and other traders is taken into account. Overall they lose money.

These are, if my interpretation is correct, important conclusions, but the three policy questions that are not addressed by Bruno`s analysis need to be answered before drawing final policy implications. Let me be more specific.

If one could conclude that there have been over the last few years innovations in market organization - essentially IT developments - leading to easier matching of "natural" sellers and buyers, then the fact that securities warehousing is more difficult, because of regulation constraining banks proprietary trading, is less of a problem and could be more easily offset by the financial stability advantages of such a regulation. An analogy with "just in time" manufacturing, where there is much less need of warehousing of intermediate goods, is obvious here. The same kind of reasoning can be made on a prospective basis: if the market needs time to adapt its organization to the weaker presence of warehousing agents, then the disadvantage of lesser proprietary trading is only temporary.

A similar argument can be made about the better distribution and process of information: if prices are more firmly anchored by available fundamental information, the fact that the action of proprietary traders, which are less affected by adverse selection, finds an obstacle in regulation is less of a problem. And again the price of less buffering could be more easily paid for the sake of more financial stability.

The third point I mentioned above is whether better funding liquidity provided by more abundant central bank liquidity can offset the negative effect of the weakening of the stabilizing function of proprietary trading. Thisfactor can have some relevance for the short and medium run, but is the least important on a medium to long-term basis. Indeed one hopes that central banks will not need to maintain their exceptionally large provision of liquidity on a permanent basis.

In conclusion, I am keen to hear from Bruno if he shares my conclusions on the three policy issues for which his paper carries relevant information. In my understanding, Bruno`s paper advances our knowledge of who provides liquidity and raises a question mark about the effect on liquidity of the new regulatory constraints on banks to carry out proprietary trading. In addition, Bruno`s paper does not, in my view, identify a clear social value in fast trading. However, before translating these analytical points in policy conclusions, more evidence is needed on other important aspects of market organization, which are not addressed in the analysis.