

Discussion

Endogenous Liquidity and Interdealer Trading in OTC Markets

(Garratt, Martin, Lee & Townsend)

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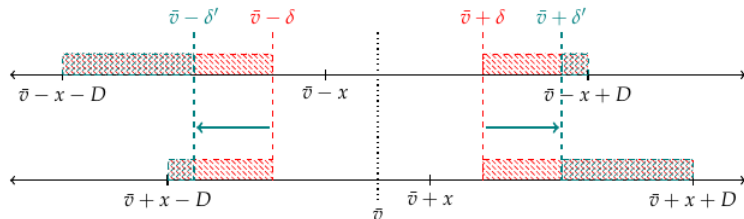
EoP IX

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How do things work? Part 1

Dealers post a bid-ask spread δ and meet trader.

- uncertainty about quality of asset (common value $\bar{v} \pm x$)
- uncertainty about gains from trade (private value $[-D, D]$)



- 1) Monopoly trade-off: trade probability lower, profit per trade higher.
- 2) Information trade-off: trade probability lower, but better informed.

How do things work? Part 2

Dealers have costs of carrying inventory (why talk about CCP?).

Interdealer market can off-set trades (good) ...

... but also transmits information (good/bad).

Result:

- only trade to offset positions
- imperfect information aggregation

3) Liquidity trade-off: higher bid-ask spread implies less trade & less need for liquidity.

How do things work? Part 3

Equilibrium strategy and profits:

$$\delta = \frac{2D^2 + x^2 + \Delta D}{4D - \Delta}$$

$$\Pi(\delta, \delta) = \delta \frac{D - \delta}{D} - \frac{x^2}{D} - \Delta \frac{D^2 + x^2 - \delta^2}{2D^2}$$

- monopoly
- adverse selection
- liquidity cost

“Strategic Externalities”:

- rents from information lead to too much info acquisition
- trading probability does not take into account increasing liquidity in the interdealer market

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Why should we care about the model?

Transparency: Trade Repository

Reveal all trades after initial trading ...

... *before* the interdealer market.

This removes incentives to strategically acquire information with a higher bid-ask spread.

Bid-ask spreads are lower and “market liquidity” is higher.

Cool ...

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Cool ...

... but all dealers are better off.

So why took it so long to get there?

Lemonade: Adverse Selection and Liquidity

There are multiple equilibria \implies financial fragility.

With high adverse selection (x large) and high position costs (Δ high) we get

- interdealer market breaks down ...
- lower market making ...
- ... and locally full revelation of information.

The interaction (a bit strange?) between liquidity cost and adverse selection could be interesting for policy makers.

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More useful than Lagos, Rocheteau and Weill (JET 2011)?

More useful than Chiu and Koepl (2009, REStud 2016)?

Conclusion

Very nice and elegant framework.

Needs to be relevant for me to put it in my backpack.

Suggestion: seek a bigger question/implication!

Maybe a new route to countercyclical risk management policies?

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Thanks for a (potentially) important model ...

... and a great conference!