Information Asymmetries, Volatility, Liquidity, and the Tobin Tax

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Outline

1. The Bigger Picture
   - Introduction
   - (Other) Related Literature

2. The Model
   - Set Up
   - Equilibrium
   - Time Change(s) and Lower Frequencies

3. Conclusion

Appendix
In market data:

- Volatility is time varying and clusters at high/medium frequency ⇒ ARCH/GARCH/SV models
- Highest degree of clustering at high frequency.
- Market vol ≠ fundamental vol (e.g. Campbell-Kyle (1993)).
- A relation between volatility and number/volume of trade (e.g. Gallant-Rossi-Tauchen (1992), Jones-Kaul-Lipson (1994)) & frequency matters (e.g. Engle-Sun (2007)).

⇒ Gaussian log returns under a number of trades (stochastic) time change (Ané-Geman (2000)).

- A link between information asymmetries, volatility and liquidity, and return dynamics (e.g. Kelly-Ljungqvist (2013), Easley-Hvidkjaer-O’Hara (2002)).

Our paper: a (non trivial) theory that can explain all the above facts and, more broadly, the equilibrium determinants of volatility (at different frequencies), and liquidity (tightness, depth, resilience).
(Other) Related Literature

  
  **But:** a) complete order book; b) dynamic info; c) *weakly* exogenous arrival process; d) arrival intensity to infinity $\to$ approximate continuous market $\to$ make arrival process irrelevant;


  $\Rightarrow$ a distributional characterisation (via stochastic time change) of equilibria on different time scales (trade, calendar, business).

- **M.M. Invariance** Kyle-Obizhaeva (2011, 2013) $\to$ same M.M. characteristics for different stocks in “business time.”

  **But:** in our case it is an equilibrium property.

Market Structure

Assets: a riskless bond \((r = 0)\) and a stock with final value \(e^{D_T}\)

\[
dD_t = \mu dt + \sigma dW^d_t, \quad D_0 = \text{const}, \quad W^d_t \text{ is B.M. w.r.t. to } \mathcal{F}_t.
\]

Utilities: risk neutral traders and (competitive) market maker (M).

A1: Traders arrive to the market and meet M according to a stochastic counting process, \(N_t\), with stopping times

\[
\theta_i = \inf \{ t \geq 0 : N_t = i \} \quad \text{and} \quad \sigma \left\{ N_{\theta_i+t} - N_{\theta_i}, t \geq 0 \right\} \perp \mathcal{F}_{\theta_i} \forall i, N_T < \infty \text{ a.s.}
\]

- When the trader arrives at time \(\theta_i\), she observes bid, \(B_{\theta_i}(v^-)\), and ask, \(A_{\theta_i}(v^+)\), prices per-share posted by M, and decides if and how much to trade \((v \in \mathbb{R})\).

Friction: proportional transaction cost \(\delta\) (like Tobin tax), aka M receives \(v^+ A_t(v^+) (1 - \delta)\) (spends \(v^- B_t(v^-) (1 + \delta)\))

if \(v = 0\) M does not observe the arrival.

Notation: \(L_t\) = cumulated # of trades, \(V_t\) = cumulated volume, \(P_t\) = price.
Information Structure

- Common knowledge: preferences, parameters, and
  \[ G_t^M := \mathcal{F}_t^P \vee \mathcal{F}_t^V \]

I type: \( i \)-th (more) informed trader, in share \( 1 - q \), knows
\[ G_t^{I, i} = G_t^M \vee \mathcal{F}_t^D \vee \sigma \left\{ \theta_i^I \wedge s, s \leq t \right\} \]

U type: \( i \)-th uniformed/liquidity/noisy, in share \( q \), with \( \delta \in (0, q) \),
trader knows \[ G_t^{U, i} = G_t^M \vee \sigma \left\{ S_{\theta_i^U} \right\} \vee \sigma \left\{ \theta_i^U \wedge s, s \leq t \right\} \]

A2: \( \mathcal{F}_T^W, \mathcal{F}_T^N \) and \( S_{\theta_i} \) are conditionally independent given \( \mathcal{H}_{i-1} \forall i \),
where \( \mathcal{H}_i = G_{\theta_i}, G_t = \mathcal{F}_t^V \vee \mathcal{F}_t^N \).

A3: \( I_i \) is independent of \( \mathcal{F}_T^{N,S,D} \vee \sigma (U_k)_{k \neq i} \)

A4: \( \mathbb{P}(v_i \in C|\mathcal{H}_{i-1}, I_i, \theta_i) = \mathbb{P}(v_i \in C|\mathcal{H}_{i-1}, U_i, \theta_i) \) for \( C \in \mathcal{B}(\mathbb{R}) \)
Traders’ optimisation problem

Notation: $z_i$ (shadow price) is the expected value of holding one share of the asset for the agent that arrives at time $\theta_i$

$$z_i = 1_{\{I_i\}} z^I_i + 1_{\{U_i\}} z^U_i.$$ 

- The expected utility from holding $v^+$ shares until time $T$ for an agent of type $k \in \{I, U\}$ that arrived at $\theta^k_i$ is

$$\mathbb{E} \left[ v^+ e^{DT} \mid \mathcal{H}^k_i \right] =: v^+ z^k_i.$$ 

- The expected utility from investing in the risk free asset the amount needed to buy $v^+$ shares at time $\theta^k_i$ is $v^+ A_{\theta^k_i} (v^+).$

$\Rightarrow$ the expected utility can be expressed as:

$$\max_{v^+, v^-} v^+ \left[ z^k_i - A_{\theta^k_i} (v^+) \right] + v^- \left[ B_{\theta^k_i} (v^-) - z^k_i \right]. \quad (1)$$
Lemma (Trader’s optimal demand)

Suppose $A_t(v^+), B_t(v^-)$ satisfy regularity conditions C1-C6. Consider a trader who arrives on the market at time $\theta_i$ and observes the posted prices $A_{\theta_i}(v^+)$ and $B_{\theta_i}(v^-)$. Then

- if $z_i > A_{\theta_i}(0)$, $v^* > 0$ is the unique solution of
  \[
  z_i = A_{\theta_i}(v) + vA'_{\theta_i}(v) \tag{2}
  \]
- if $z_i < B_{\theta_i}(0)$, $v^* < 0$ is the unique solution of
  \[
  z_i = B_{\theta_i}(-v) - vB'_{\theta_i}(-v) \tag{3}
  \]
- if $B_{\theta_i}(0) \leq z_i \leq A_{\theta_i}(0)$, then the optimal order size is $v^* = 0$.

where $z_i$ is the stock’s valuation of the trader.
Market Maker’s optimisation problem

- Need a (non-falsifiable) belief of M about $N_t$. We assume that $N_t = L_t \Rightarrow$ M doesn’t update her beliefs if no trade occurs.

Notation: M’s utility from owning one share of the stock until $T$ is

$$Z_t^M := \mathbb{E} \left[ e^{DT} \bigg| G_t^M, N_t = L_t \right].$$

- M sets time $t$ bid and ask prices as a functions of the order size $v$:

$$A_t (v^+) (1 - \delta) = \sum_{i=1}^{\infty} \mathbf{1}_{\{i=1+L_t-\}} \mathbb{E} \left[ e^{DT} \bigg| \tilde{H}^M_i, N_{\tau_i} = L_{\tau_i} \bigg| \tilde{v}_i = v^+, \tau_i = t \right],$$

M’s valuation

$$B_t (v^-) (1 + \delta) = \sum_{i=1}^{\infty} \mathbf{1}_{\{i=1+L_t-\}} \mathbb{E} \left[ e^{DT} \bigg| \tilde{H}^M_i, N_{\tau_i} = L_{\tau_i} \bigg| \tilde{v}_i = -v^-, \tau_i = t \right].$$
Proposition (Optimal ask and bid functions)

Suppose assumptions A1-A5 are satisfied. Then there exist optimal ask, $A_t(v^+)$, and bid, $B_t(v^-)$, prices that satisfy conditions C1-C5, and the market maker’s optimality conditions. Moreover, optimal $A_t(v)$ and $B_t(v)$ have the following forms:

$$A_t^*(v) = \frac{q}{q - \delta} \left(1 + \alpha v^{\frac{q - \delta}{1-q}} \right) \sum_{i=0}^{\infty} 1_{\{i=L_t-1\}} Z^M_{\tau_{i-1}}$$  \hspace{1cm} (6)$$

$$B_t^*(v) = \left\{ \begin{array}{ll}
\frac{q}{q + \delta} \left(1 - \beta v^{\frac{q + \delta}{1-q}} \right) \sum_{i=0}^{\infty} 1_{\{i=L_t-1\}} Z^M_{\tau_{i-1}} & \text{if } \beta v^{\frac{q + \delta}{1-q}} \leq 1 \\
0 & \text{otherwise}
\end{array} \right.$$

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0 & \text{otherwise}
\end{array} \right.$$

where $\alpha$ and $\beta$ are strictly positive arbitrary constants, and $Z^M$ denotes the market maker valuation.
Equilibrium Bid and Ask functions

- order book interpretation (M analogy).
- flexible parametrisation and empirically promising.
Liquidity: Tightness

\[
\frac{\% \text{ Bid-Ask spread at } 0}{= \frac{2q\delta}{q^2 - \delta^2}}
\]

B-A ↑ in adverse selection \((1 - q)\) and trading cost \((\delta)\)
- mutually reinforcing effects

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Liquidity: Depth

Slope of the Ask schedule, normalised by M’s valuation: \( \frac{q}{1-q} \alpha (v^+)^{\frac{2q-d-1}{1-q}} \).

Note: Loeb (1983) and Keim and Madhavan (1996) find that the price impact per unit trade is smaller for large orders.
High Frequency Price Process

Since trades happen either at ask or bid, we can characterise the price process for any volume process:

\[
\log \frac{P_{t+s}}{P_t} = \sum_{i=L_t}^{L_{t+s}} \left\{ \log \left(1 + \xi_i \left| V_{\tau_i} - V_{\tau_{i-1}} \right| \gamma_i \right) + \log c_{1,i} + \log c_{2,i-1} \right\}.
\]

(8)

where \(\xi_i, \gamma_i, c_{1,i} \) and \(c_{2,i}\) are known functions of \(\delta, q\), and whether trades are at ask or bid (the latter is a binomial r. v.).


if \(\left| \xi_i \right| \left| V_{\tau_i} - V_{\tau_{i-1}} \right| \gamma_i\) is

Small \(\approx\) power law relationship (e.g. Farmer and Lillo (2004) and Farmer, Lillo, and Mantegna (2003))

Large \(\approx\) log-log relationship (e.g. Potters-Bouchaud (2003)).
Theorem

Suppose Assumptions A1-A5 are satisfied. For strictly positive constants $\alpha$ and $\beta$, there is a unique market equilibrium, $A^*_t(v)$, $B^*_t(v)$, $v^*_i$, where $A^*_t(v)$ and $B^*_t(v)$ are given, respectively, by equations (6) and (7), and

$$v^*_i = \begin{cases} 
\left[ \frac{1-q}{\alpha(1-\delta)} \left( \frac{q-\delta}{q} z^M_i - 1 \right) \right] \frac{1-q}{q-\delta} & \text{if } \frac{q}{q-\delta} z^M_i < z_i, \\
- \left[ \frac{1-q}{\beta(1+\delta)} \left( 1 - \frac{q+\delta}{q} z^M_i \right) \right] \frac{1-q}{q+\delta} & \text{if } z_i < \frac{q}{q+\delta} z^M_i, \\
0 & \text{if } \frac{q}{q+\delta} z^M_i \leq z_i \leq \frac{q}{q-\delta} z^M_i
\end{cases}$$

where $z^M_i := Z^M_{\theta_i}$
Lemma (price process as map of fundamentals)

*Suppose that Assumptions A1-A5 are satisfied and the market is at the equilibrium. Then the trading times are defined recursively ($\tau_0 = 0$)*

$$
\tau_i = \inf \{ \theta_j > \tau_{i-1} : \log z_j - \log \tilde{p}_{i-1} \notin (b(c_2,i-1), a(c_2,i-1)) \},
$$

where $a(x) = \log \left( \frac{q x}{q-\delta} \right)$ and $b(x) = \log \left( \frac{q x}{q+\delta} \right)$, and prices are

$$
\tilde{p}_0 = e^{D_0 + (\mu + \frac{1}{2} \sigma^2) T}, \quad \tilde{p}_i = \frac{1}{c_{2,i}} \left[ (1 - q) z_i + q \tilde{p}_{i-1} c_{2,i-1} \right], \quad (9)
$$

$$
c_{2,i} = \begin{cases} 
1 - \delta & \text{if } \log \tilde{z}_i - \log \tilde{p}_{i-1} > a(c_{2,i-1}) \text{ and } i > 0 \\
1 + \delta & \text{if } \log \tilde{z}_i - \log \tilde{p}_{i-1} < b(c_{2,i-1}) \text{ and } i > 0 \\
1, & \text{if } i = 0
\end{cases}
$$
The process $Z$ (Shadow Price)

We will work with the value of the log profit of the last agent that arrived before $t$, $D_{tr}^t$, given by

$$d_{tr}^i = \begin{cases} 
\log z_i - \left(\mu + \frac{\sigma^2}{2}\right)(T - \theta_i) & \forall i \geq 1 \\
D_0 & i = 0
\end{cases}, \quad D_{tr}^t = \sum_{i=0}^{\infty} 1_{\{i=N_t\}} d_{tr}^i.$$

The distribution of the process $D_{tr}^t$ is (Lemma 3):

$$\mathbb{P} [d_{tr}^i \leq x | \mathcal{H}_{i-1}, \theta_i] = (1 - q) \sum_{j=1}^{i-1} q^{i-1-j} \mathbb{P} [d_{tr}^j + \varepsilon_{i,j} \leq x | d_{tr}^j, \Delta_{i,j}] + q^{i-1} \mathbb{P} [d_{tr}^0 + \varepsilon_{i,0} \leq x | d_{tr}^0, \Delta_{i,0}]$$

where $\Delta_{i,j} := \theta_i - \theta_j$, $\varepsilon_{i,j} := \mu \Delta_{i,j} + \sigma \sqrt{\Delta_{i,j}} \eta_{i,j}$, and $\eta_{i,j} \sim N(0,1)$ is independent of $d_{tr}^j$ and $\Delta_{i,j}$ for all $j < i$. 

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Sequence of Markets in a Nutshell

Arrival intensity \( \rightarrow \infty \) ("business time") \( \Rightarrow \) valuation of \( i \)-th arrival \( (D^{tr}) \xrightarrow{\mathcal{L}} \text{to B.M. (Prop. 9)} \Rightarrow \) Trade occurs when B.M. touches B-A bounds \( + \)

The map from \( D^{tr} \) to \( P \) is continuous (Lem. 5) \( \Rightarrow \)

Price \( \xrightarrow{\mathcal{L}} \) on trade time (Thm. 7) \( \Rightarrow \) Calendar time dist. = time change wrt trades per time (Prop. 9) \( \Leftrightarrow \) S.V. driven by \# of trades
Corollary (Volatility of the Limiting Price Process)

The conditional variance on the trade time scale, for \( i > 1 \), is:

\[
\text{Var} \left( \frac{\tilde{p}_i}{\tilde{p}_{i-1}} \bigg| F_{\tau_{i-1}} \right) = \frac{\delta^2(1 - q^2)}{q^2 - \delta^2}.
\]

↑ in adverse selection and \( \delta \) (cf. Hau (2006), Jones-Seguin (1997), Umlauf (1993))

⇒ Tobin Tax reduces (increases) Vol. in calm (hectic) times.

• mutually reinforcing effects.
Proposition (Low/Ultra-Low Frequency Price Distribution)

\[
\log \frac{P_t}{P_s} - \frac{\sigma^2}{2} (s - t) \quad \sqrt{L^p_t - L^p_s} \quad \frac{d}{t-s \to \infty} \mathcal{N} \left( 0, \sigma^2 \mu_\tau \right), \\
\]

where \( \mu_\tau \) is the expected time between trades. And at Ultra-low frequency

\[
\log \frac{P_t}{P_s} - \frac{\sigma^2}{2} (s - t) \quad \frac{d}{\sqrt{t-s} \to \infty} \mathcal{N} \left( 0, \sigma^2 \right). \\
\]


Note: second result due to \( L^p_t / t \overset{a.s.}{\to} 1/\mu_\tau \).
Expected time between trades ($\mu_\tau$)

\[ \mu_\tau := \frac{2}{\sigma^2} \left[ \log \frac{q - \delta}{q(1 - \delta)} + \frac{(q + \delta)(1 + \delta)}{2(q + \delta^2)} \log \frac{(1 - \delta)(q + \delta)}{(1 + \delta)(q - \delta)} \right] \]

↑ in adverse selection $(1 - q)$ and trade cost $(\delta)$

● mutually reinforcing effects
Liquidity: Resilience

Note: on the trade time scale, the market maker valuation evolves as

\[ \tilde{z}_i^M = (1 - q) \tilde{z}_i + q \tilde{z}_{i-1}. \]  
(12)

(i.e. an AR(1)) where \( \tilde{z}_i \) is the valuation of the \( i \)-th trader.

Hence: half-life (reciprocal of resilience) on the calendar time scale:

\[ \frac{\ln 1/2}{\ln q} \times \frac{\mu}{\tau} \]

- trade-by-trade half-life
- expected time between trades

w.r.t. \( \delta \): same properties as \( \mu \tau \Rightarrow \uparrow \) in \( \delta \) (consistent with Umlauf (1993)):
- resilience \( \downarrow \) in \( \delta \) (Tobin Tax)

w.r.t. \( q \): two opposing effects:
1. \( \mu \tau \downarrow \) in \( q \)
2. trade-by-trade half-life \( \uparrow \) in \( q \)

overall: calendar time half-life \( \downarrow \) in \( q \): resilience \( \downarrow \) in adverse selection

- mutually reinforcing negative effects
Conclusion

A simple and tractable equilibrium framework that:

1. can rationalise a very large set of empirical findings about financial market volatility and returns at different frequencies.
2. identifies the equilibrium determinants of the 3 main liquidity dimensions, and can rationalise related empirical findings.
3. delivers policy relevant (and empirically consistent) predictions about the Tobin Tax.
4. can be structurally estimated to pin down asset specific measures of: asy. info., frictions to trade, liquidity, fundamental vol etc. ⇒ empirical follow up.
5. provides a novel approach for the study of equilibrium dynamics (at multiple frequencies) for very different economic problems (e.g. sticky prices/wages/information, endogenous consumption optimisation etc.)
Appendix

4 Additional Figures
- Ané and Geman (2000)
- Bid-Ask Curves

5 In a Nutshell

6 Extras
- Time Scales
- Regularity Conditions
- Equilibrium Definition
Additional Figures
In a Nutshell
Extras

Ané and Geman (2000)
Bid-Ask Curves

Source: Ané and Geman (2000)
PANEL B. Estimated density of the Cisco Systems 10-minute return conditioned on the re-centered number of trades

Source: Ané and Geman (2000)
Additional Figures
In a Nutshell
Extras

Ané and Geman (2000)
Bid-Ask Curves

Only uninformed traders trade

Both informed and uninformed traders trade

Price

Order size (v)

True Value

B*(v)

A*(v)

B*(v)

A*(v)

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Resilience: calendar time half-life of M’s update

Panel A

- q = 0.5
- q = 0.25
- q = 0.75
- sigma = 0.155

Panel B

- d = 0.01
- d = 0.005
- d = 0.015
- sigma = 0.155

negative effects of trade and adverse selection costs on resilience mutually reinforce
In a Nutshell

- for (non trivial) heteroscedasticity, need the conditional and unconditional information reflected into prices to be different.

⇒ Asym. information + trade friction ($\delta$) (for B-A spread)

High freq.: trade-by-trade price process adapted to info process:
no SV in the latter ⇐ no SV in the former.

But: trade $t \neq$ calendar $t$ (in equilibrium)

\[ t = 1 \quad t = 2 \quad t = 3 \quad t = 4 \quad t = 5 \quad t = 6 \quad t = 7 \]

Arrival time, $\theta$

Trade time, $\tau$

Calendar time, $t$
In a Nutshell cont’d

Med freq. := arrival rate $\rightarrow \infty$ i.e. “business time” $\Rightarrow$ Number of trades becomes the relevant information (no residual info in volume).

- Trade-by-trade Price Vol $\uparrow$ in $\delta$ and adverse selection

$\Rightarrow$ Tobin tax: $\downarrow$ Vol in calm times, and $\uparrow$ Vol in hectic ones.

- Price SV on calendar time driven by number of trades.

Low freq. := number of trades per time is "large"

- Trades per time $\downarrow$ in $\delta$ and adverse selection.

Tradeoff: calendar Vol $\approx$ Trade-by-trade Vol $\times$ Trades per time.

$\Rightarrow$ Vol $\uparrow$ in $\delta$ and adverse selection.

Tobin Tax:

- Vol $\uparrow$
- $\downarrow$ “Tightness” & “Resilience” (small impact on depth)
- stronger effect in less liquid markets
Review of Time Scales

Arrival time, $\theta$

Trade time, $\tau$

Calendar time, $t$

Trade 1, Trade 2, Trade 3, Trade 4, Trade 5, Trade 6, Trade 7

Arrival 1, Arrival 2, Arrival 3, Arrival 4, Arrival 5, Arrival 6, Arrival 7, Arrival 8, Arrival 9, Arrival 10, Arrival 11, Arrival 12, Arrival 13, Arrival 14, Arrival 15

$t = 1, t = 2, t = 3, t = 4, t = 5, t = 6, t = 7$
Regularity Conditions

C1 For a fixed $v$, the processes $B_t(v^-)$, $A_t(v^+)$, are cáglád
aka: M can change prices at any time but the time of trade.
C2 For a fixed $t$, $A_t(v^+) : \mathbb{R}_+ \rightarrow \bar{\mathbb{R}}_+ \setminus \{0\}$ is continuous, nondecreasing and \( \lim_{v^+ \rightarrow \infty} A_t(v^+) = +\infty \).
C3 For a fixed $t$, $B_t(v^-) : \mathbb{R}_+ \rightarrow \bar{\mathbb{R}}_+$ is continuous, nonincreasing and \( \lim_{v^- \rightarrow \infty} B_t(v^-) = 0 \).
aka: no: free disposal, infinite trade size, decreasing price per-share.
C4 For a fixed $t$, $A_t(0) \geq B_t(0)$ for all $\omega \in \Omega$.
C5 For any fixed $t$, $A_t(\cdot)$ is continously differentiable, and $B_t(\cdot)$ is continously differentiable on the set \( \{v : B_t(v) > 0\} \)
C6 For a fixed $t$, $vA_t(v)$ is strictly convex, and $vB_t(v)$ is strictly concave on the set \( \{v : B_t(v) > 0\} \)
aka: C5-C6 ensures strict concavity of traders’ problem.
**Equilibrium: Definition**

**Definition (Equilibrium)**

A market equilibrium is a set of policy functions $A_t(v^+), B_t(v^-)$ satisfying regularity conditions and $v_i(A_{\theta_i}(v^+), B_{\theta_i}(v^-))$ such that:

1. $A_t(v^+)$ and $B_t(v^-)$ solve the market maker optimisation problem $\forall v, t$;
2. $v_i(A_{\theta_i}(v^+), B_{\theta_i}(v^-))$ solves the trader’s problem.