Detecting information-driven trading in a dealers' market

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Non-Technical Summary

The article explores differences in the behavior of Czech market makers on the Prague Stock Exchange (PSE) which might suggest informational advantages of some of them. Due to the specifics of this small emerging market, every large order affects the price on the market significantly. The market microstructure of the Czech capital market allows large investors to negotiate the price for large block trades with the market makers. In other words the market makers and large investors often share private information. Such a practice may lead to a situation in which several of the market makers possess better information than the rest of the market.

The authors use the classical Easley et al. (1996) model in a combination of a probability of informed trading measurement and a jackknife approach in which trades of one particular market maker at a time are left out from the sum of all buys and sells. Using the estimates from the jackknife approach, for each market maker the authors construct and test whether the market maker behaved significantly different from the others.

The findings indicates:

- Significant differences in the behavior of market makers
- Market makers affect the extent of information-driven trading
- Surprisingly long periods of time of different behavior of particular market makers

Although the other participants on the market may be aware that some of the market makers may possess private information about the value of an asset they are not able to reveal their whole information. The study should, therefore, contribute to the development of detection mechanisms used by regulatory authorities on emerging markets in identifying the suspicious behavior of particular market participants.