‘High-frequency trading: what is it good for?’

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ABSTRACT:

High-speed computerized trading, often called “high-frequency trading” (HFT), has increased dramatically in financial markets over the last decade. In the US and Europe, it now accounts for nearly one-half of all trades. Although evidence suggests that HFT contributes to the efficiency of markets, there are concerns it also adds to market instability, especially during times of stress. Currently, it is unclear how or why HFT produces these outcomes. In this paper, I use data from NASDAQ to show that HFT synchronizes prices in financial markets, making the values of related securities change contemporaneously. With a model (and drawing parallels with recent work in ecology), I demonstrate how price synchronization leads to increased efficiency: prices are more accurate and transaction costs are reduced. During times of stress, however, localized errors quickly propagate through the financial system if safeguards are not in place. In addition, there is potential for HFT to enforce incorrect relationships between securities, making prices more (or less) correlated than economic fundamentals warrant. This research highlights an important role that HFT plays in markets and helps answer several puzzling questions that previously seemed difficult to explain: why HFT is so prevalent, why HFT concentrates in certain securities and largely ignores others, and finally, how HFT can lower transaction costs yet still make profits.