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# Informed trading and the bid–ask spread: evidence from an emerging market ☆

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The bid–ask spread affects significantly the performance of financial markets. We explore the impact of informed trading on the composition of the bid–ask spread in high frequency data from the Czech equity market, which has been plagued by informed trading due to insufficient regulation and missing institutions. Our estimates suggest that the Czech market-maker based trading system is rather efficient in dealing with informed trading. Only 17% of the bid–ask spread is explained by informed trading, which corresponds roughly to the share of the adverse-selection component in developed markets. An explanation based on the difference between the posted and traded spreads is offered. *Journal of Comparative Economics* **31** (2) (2003) 275–296. CERGE-EI, PO Box 882, Politických vězňů 7, 111 21 Prague, Czech Republic; International Monetary Fund, Monetary and Exchange Affairs Department, 700 19th Street N.W., Washington, DC 20431, USA.
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## 1. Introduction

Since the bid–ask spread is an important determinant of trading costs and, thus, impacts significantly the performance of financial markets, the link between informed trading or the adverse selection of traders and the bid–ask spread is the focus of much research.[1] Some authors have suggested that, if informed trading is common, it might lead to market shutdown as the spread would simply be too wide for investors to participate in trading. Historically, the bid–ask spread has been regarded as a function of order processing and inventory costs. More recent financial research introduces adverse selection and informed trading to the explanation. As a provider of liquidity, the market maker always quotes prices for transactions and faces the possibility of trading with agents who have superior information. The market maker loses money in trades with such individuals and, thus, sets a spread between the bid and ask price to compensate for this adverse selection problem. Glosten and Milgrom (1985) show formally that, with informed trading, a bid–ask spread would exist even in the absence of order processing or inventory costs. Thus, the current financial literature distinguishes three components of the bid–ask spread, that is, inventory costs, order processing costs, and adverse selection.

Although many empirical studies try to estimate the components of the bid–ask spread, the size of the adverse-selection component is not fully resolved. Earlier studies suggest that its share is large; e.g., Stoll (1989), using a sample of NASDAQ stocks, reports that 43% of the quoted spread is due to adverse selection. On the other hand, George et al. (1991) estimate a much smaller share for adverse selection; in a sample of NYSE, AMEX, and NASDAQ stocks, they put this share in the range of 8 to 13%. Huang and Stoll (1997) develop a general model to offer two ways of decomposing the spread and also estimate two values of this share, namely 9.6 and 21.5%. These differences in the estimated shares due to adverse selection are difficult to explain because the cited studies differ both in data and estimation methodology. Overall, the more recent studies appear to suggest that the share of the adverse selection component is rather low in developed markets.

The current paper investigates the bid–ask spread in the Czech stock market, focusing on the adverse selection component. Our study uses high frequency data to provide evidence on the composition of the bid–ask spread from an emerging market. Previous studies have dealt almost exclusively with US markets and, except for the most recent studies, have used only daily and weekly data. In estimating the adverse-selection component, we combine the recent findings of the inventory literature with older methods of estimation. In the previous literature, the distinction between competitive market makers and a single specialist was largely ignored, perhaps due to the use of less detailed data. Our analysis offers an insight into the magnitude of the adverse-selection component in a market known for being plagued by insider trading.

From the outset, the Czech equity market developed very rapidly, since many companies were floated as a result of coupon privatization. However, market regulation lagged significantly. Insider trading, price manipulation, fraud in the investment funds industry, and abuses of minority shareholder rights eroded investor confidence. In recent years,

[1] The bid–ask spread is defined as the difference between the price at which the market maker is willing to sell and the price at which he is willing to buy.

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