

# Liquidity Supply in multiple markets

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**Preliminary version**  
**January, 2006**

## **Abstract**

Using an inventory model based on Ho and Stoll (1983), this paper examines how two competing risk-averse dealers supply liquidity in two different market systems. We find that price formation and market spreads are directly impacted by the way order flows are correlated in systems. If order flows are negatively correlated, dealers expect to better manage their inventory position and markets spreads reduce. When order flows are positively correlated, dealers are more likely to be touched on the same side which increases their inventory risk and market spreads increase. Further, this model sheds new light on some empirical results (Gresse [2001], Hansh [2001] or Werner and Kleidon [1996]) and it has some new direct empirical predictions.

**Keywords:** Hybrid Market, Market competition, Interdealer trading, Market fragmentation.

**EFM Classification code:** 360.