
Financial Market Arbitrage: Reassuring or Lovely?



By [Antonio Fatas](#) , INSEAD Professor of Economics

High speed trading may reduce price deviations but does it get financial prices right?

High frequency trading makes the co-movements of two markets stronger. The theory was tested in recent research by [Budish, Cramton and Shim](#) whose paper shows that as high frequency trading spreads, the correlation of a particular asset price across two US markets (Chicago and New York) become higher at intervals that are very short. Any price deviations across the two markets disappear in less than one second.

John Cochrane summarized the paper in his new [blog post](#) noting,

It is lovely to see the effect of "arbitrageurs" making markets "more efficient."

The post is a great example of what we look for in academic papers, a clean test of a very simple theory that produces very credible and robust results.

But as much as I enjoyed reading it, it also reminded me of how limited academic research is in helping help us understand phenomena that really

matter.

In this particular case, the analysis compares the price of the same security in two nearby markets (geographically but also linked by very fast communications). As communications and trade become faster and faster, price deviations between the two markets disappear in a shorter period of time.

While this is nice to see is it a big surprise? One would expect that at a minimum very basic arbitrage opportunities do not exist in integrated financial markets. While it's reassuring that arbitrageurs help markets to become more efficient, I'm not sure I would go as far as saying that this is "lovely".

What would be more interesting (at least to me) is to understand whether high frequency trading helps in getting financial prices right. And by "right" I mean prices that are consistent with economic fundamentals; prices that do not generate volatile dynamics and bubble-type behavior.

If we could prove that this is the case then I would find the result "lovely".

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About the author(s)

Antonio Fatas is a Professor of Economics at INSEAD. He is also a Research Fellow at the Centre for Economic and Policy Research in London and has worked as an external consultant for the International Monetary Fund, the OECD and the World Bank.