Reduced liquidity really does increase price volatility you know [1]

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One part of the drivel we hear (or hear being repeatedly asserted perhaps) about the financial transactions tax is that lots of trading increases price volatility. Thus the tax, by reducing liquidity, will reduce price volatility which would be a good thing. So tax the markets and Hurrah!

There is one slight problem with this idea. It's only a teensie problem to be sure. The teensie weensie problem being that there's absolutely no evidence whatsoever that it's true.

It's entirely possible to construct theories in which it is true: that's certain. Assume that everyone's a momentum investor, just following the herd, and it quite possibly would be true for example. But it is always necessary to benchmark such theories against the real world. As an example, I've always been quite taken with the theory that The Moon is made of green cheese. That has indeed been tested and no, Neil Armstrong was not able to consume regolith on a Jacobs Cream Cracker. So it is with this idea that increasing liquidity in a market increases price volatility: or the inverse, that reducing it would reduce such [3] .

> Eric Hunsader at Nanex presents us with a nice start to 2013 markets ? a no less than an 8 per cent drop and subsequent clawback in natgas futures during early Thursday trade: That?ll teach you for not waiting for a bit more liquidity later in the day.

Interesting, isn't it? How actual facts often upset the wilder suppositions put forward by those who would tax us all more?

Indeed, there's almost certainly a Ph.D thesis in there for someone who wants to do it. Take 20 or 50 different markets (and cover different things, stocks, bonds, derivatives, commodites), in different countries, with different holiday periods. Compare and contrast price volatility in those markets with those holiday periods and reduced volumes and liquidity.

My bet is that we'll see increased price volatility in circumstances of reduced liquidity. And to supporters of financial transactions taxes (and the idiocy that is the Robin Hood Tax) if you're so sure of your claim, why haven't you done this analysis already to prove your point to us?

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