Does Insider Trading Raise Market Volatility?

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Summary

Stock markets are volatile. That is not news. But the volatility varies substantially across countries. Suppose we use the standard deviation of the monthly returns of a major market index as the measure, then the volatility in Japan or Italy is typically twice as high as in the United States. The volatility in developing countries is typically even higher. For example, the Chinese and the Russian markets, respectively, are nearly 600% and 800% as volatile as the U.S market.

Market volatility affects the incentive to save and to invest. In almost any model with representative agent maximizing utility under uncertainty, the more volatile the asset market, holding the average return constant, the less the agent will save, and hence the less the investment will be. A certain degree of market volatility is unavoidable, even desirable, as one would like the stock price fluctuation to indicate changing values across economic activities so that resources can be better allocated. However, precisely because stock prices are supposed to serve as signals for resource allocation, excessive volatility that is not related to economic fundamentals would diminish the signaling function and impede resource allocation

This paper studies the role of insider trading in explaining cross-country difference in the stock market volatility. It introduces a new (albeit imperfect) measure of insider trading for 50 or so countries. The central finding is that countries with more prevalent insider trading do have more volatile stock markets, even after one controls for liquidity/maturity of the market, and the volatility of the underlying fundamentals (volatility of real output, and monetary and fiscal policies). Moreover, the effect of insider trading is quantitatively significant when compared with the effect of economic fundamentals.