DEALER INTERMEDIATION BETWEEN MARKETS

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Abstract
We develop a dynamic model of dealer intermediation between a monopolistic customer-dealer market and a competitive interdealer limit order market. Dealers face inventory constraints and adverse selection. We characterize the optimal quote setting and inventory management behavior for both markets in closed form and reveal how price setting in one market segment influences quote behavior in the other. The framework is used to explore market stability issues of the two-tier market structure and delivers testable predictions about how the dispersion of retail prices is related to the state of the interdealer limit order book. Data from the European sovereign bond market is used to test for inventory related retail price dispersion. (JEL: G24, G14)

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