“Exchange Competition, Entry and Welfare”

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Abstract

We assess the consequences for market quality and welfare of different entry regimes and exchange pricing policies in a context of limited market participation. To this end we integrate a two-period market microstructure model with an exchange competition model with entry in which exchanges supply technological services, and have market power. We compare the solutions a planner achieves when it can regulate the number of exchanges populating the industry, or the technological service fee. In the first case, we show that entry has two countervailing effects on welfare: business stealing and liquidity creation. The former (latter) has a negative (positive) effect on total welfare and liquidity, and both excessive or insufficient platform entry can arise. In the second case, we show that the planner minimises entry costs by allowing only one exchange to provide technological services, and regulating the fee it charges. Because of market power, exchanges tend to under provide technological services. Therefore, by minimizing entry costs and imposing higher technological service provision, fee regulation is conducive to a superior outcome in terms of liquidity and welfare.

Keywords: Market fragmentation, welfare, endogenous market structure, platform competition, Cournot market, Industrial Organization of Exchanges.