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Intraday trading halts in the Nikkei futures market

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Abstract

The Osaka Securities Exchange (OSE) halts Nikkei 225 index-futures trading when the next transaction is to take place at a price more than ¥30 (prior to February 1994) or ¥60 (from February 1994) away from the previous trading price. This paper examines the efficacy of the intraday price limit rule in terms of price discovery, liquidity and volatility. We also include transaction data from the Singapore International Monetary Exchange (SIMEX) where Nikkei futures are traded simultaneously. The intraday price limit rule generally appears to be ineffective in reducing volatility and avoiding price jumps, at least partly because OSE traders have access to the alternative market at SIMEX. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The trading systems of Japanese securities exchanges differ strongly from the main other markets around the world. Most importantly, Japanese markets do not employ specialists, such as the ones on the New York Stock Exchange, who

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continuously provide liquidity to limit the magnitude of price changes between consecutive transactions. Instead, Japanese systems supply through a limit order book, managed by so-called *saitori* members. Saitori members solely function as middlemen in transactions between regular members of the exchange. They cannot trade for their own account, nor can they accept orders from the public. A special feature of Japan's exchanges is that liquidity is organized through restrictions on maximum price changes from trade to trade. Thus, immediacy is sometimes sacrificed by the trading system in order to slow down trading when there is an order imbalance and to generate liquidity by actively soliciting counterorders with other exchange members.

At least two studies have looked at this intraday price limit rule on the Tokyo Stock Exchange (TSE). Lehmann and Modest (1994) study transactions, best-bid and best-offer quotes for all individual stocks on the TSE over a period of 26 months. They find that intraday price limits are hit only very rarely, occurring less than once every 4 days. In general, they conclude that the TSE's trading system functions well. Hamao and Hasbrouck (1995) performed an extensive study of stock prices using transaction data from the TSE. They conclude that immediacy at the TSE appears to be "quite high" and the intraday price limit rule causes some trades to be executed more slowly, but allows many market orders to transact at better prices.

Many articles study the impact of other types of trading halts on price discovery in an effort to provide answers in the debate in policy circles on the use of trading halts in financial markets, especially since the market breaks of 1987 and 1989. Proponents argue that price limits reduce overreactions, while others suggest that price limits prevent trading altogether and therefore harm the price discovery process. Ma et al. (1989), for example, study the influence of daily price limits on the price formation process after the market has resumed trading. They conclude that price limits serve a useful function in giving the market "time to breathe". Lee et al. (1994) study circuit breakers on the New York Stock Exchange and find that trading halts are associated with increased volume and volatility, which persist for 1 day and 3 days after reinstatement, respectively. The authors therefore conclude that trading halts are not successful at fulfilling their goal of reducing "excess volatility". These results support their claim that the trading halt disrupts "learning by trading". Kryzanowski and Nemiroff (1998) investigate the price discovery process around trading halts on the Montreal Exchange. They find that volatility and trading activity increase significantly around trading halts and return to lower levels in less than 2 days after the resumption of trading. However, the halts on the Montreal Exchange appear to be less of an impediment to uncertainty resolution than halts on the NYSE (see Lee et al., 1994). Kim and Ghon Rhee (1997) study daily price limits on the Tokyo Stock Exchange and conclude that price limits are ineffective. Berkman and Steenbeek (1998) study the influence of daily price limits on the price formation process of the Nikkei 225 stock index futures contract. The Nikkei 225 futures contract is traded on both the Osaka Securities

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