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The International Journal of Business and Finance Research

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DYNAMIC RELATIONSHIPS BETWEEN ISHARES AND COUNTRY FUNDS: THE CASE OF EUROPE AND ASIA

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ABSTRACT

This study investigates whether country effects or regional effects are prominent in iShares and country funds that trade in the US. iShares and country funds from three European and three Asian countries are investigated for possible long run and short-run relationships among iShares and country funds of each country and among regional iShares and among regional country funds. Johansen's methodology is used to investigate long-run relationships, while vector autoregression is used to detect short-term effects. It is found that for both regions, iShares and country funds are related to their country counterparts but not to their regional counterparts in the short run. The reverse is true in the long run, with relationships among regional counterparts but not among country counterparts. These findings support the hypothesis that country effects are prominent in the short-run and regional effects take over in the long run.

INTRODUCTION

Diversification in international markets can be achieved by investing in various assets such as foreign stocks, mutual funds, iShares, etc. However, relationships among these assets could lead to a reduction in diversification gains. Hence, a comparison of regional or country relationships would provide immense benefit to an investor seeking diversification. An asset may show relationships with other assets of the same country or with assets of other countries in the same region. This paper hypothesizes that in the short-run, international assets may show relationships with assets of their own country, but in the long run, they are related with the regional assets. Such effects may be due to the dominance of country-related factors in the short run. However, such factors may not have any regional implications. On the other hand, in the long run, investors tend to invest on a regional basis and hence, there may be a dominance of regional factors.

To investigate this hypothesis, this paper utilizes iShares and country funds of six countries representing two regions: Asia and Europe. Only iShares and country funds have been used because they both represent a diversified portfolio in a single country. International stocks may experience an effect from company-specific (events) effects in addition to country and regional effects. This is not within the scope of this paper. iShares, which track the Morgan Stanley Capital Index (MSCI) of a specific country, comprise all the stocks included within that index. As such, they represent a passive investment in a particular country. Due to their passive nature, they have low fees. iShares can also be bought and sold at any time during a trading day for a commission. There are no early redemption fees or penalties. Closed-end country funds invest in a small sample of stocks in a specific country. Country funds are actively managed investments in a country and, hence, have higher fees than iShares. There are early redemption penalties for country funds. Regardless of their differences, they both represent a diversified portfolio that is affected by country and regional factors.

Studies in the past have investigated relationships among regional assets. For example, Dunis and Shannon (2005) investigate the diversification potential offered by the Southeast and Central Asian markets and find increased relationships with the Japanese market, but not with the US or UK markets. However, most of these relationships have been among indices representing the countries of these regions. Thus, these studies have not been able to utilize investible assets such as iShares and country funds. Studies that have investigated iShares and country funds and the effects of a country or region on them have looked at them separately, not in unison. A few studies have looked at the relationship between iShares and country funds of a specific country, but have not extended their study to include regional

CANADIAN STOCK SPLITS AND FINANCIAL ANALYST FORECASTS: TESTING SIGNALING AND ATTENTION EFFECTS

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ABSTRACT

This paper analyses Canadian market reaction to stock splits over the period 1985-2000. It then attempts to explain this reaction by two hypotheses, namely signaling and attention hypotheses. Results indicate that the Canadian market reacts positively to stock split announcements. Positive average abnormal returns of 1.76% and 1.14% are reported for the announcement date and the following day, respectively. This market reaction is partly explained by signaling hypothesis. An earning prediction error of 115.05% after the announcement date is observed, giving support to this hypothesis. However, the authors are unable to validate the attention hypothesis in Canadian markets. The average revision rate of earnings per share by financial analysts is 3.49%, but is not significant.

INTRODUCTION

Stock splitting is far from being a marginal phenomenon in Canada. It has increased with time, and is receiving more and more interest from financial analysts and investors. This operation, which increases the number of outstanding shares, decreases the price of each share, but has no effect on shareholders' proportional ownership of shares, should in theory be a purely cosmetic change that has no impact on the splitting firm's value. If the total value is independent of the number of shares outstanding, 100 shares at \$5 per share must give the same total value as 500 shares at \$1 per share. However, empirical studies usually show that a stock split is far from being a purely cosmetic event. They report a positive market reaction to stock split announcements, thus creating a conflict between theory and practice.

There are several papers on US market reactions to stock splits, but few on Canadian market reactions (papers on Canadian markets include Charest, 1980; Kryzanowski & Zhang, 1991, 1993, 1996; Masse, Hanrahan & Kushner, 1997; and Elfakhani & Lung, 2003). Moreover, with the exception of Kryzanowski and Zhang (1996) and Elfakhani and Lung (2003), these Canadian studies do not provide explanations for the positive market reaction surrounding stock split announcements, the interest of the present paper. This paper's concern with analysis of Canadian market reaction to stock split announcements also derives from differences between US and Canadian financial markets. Canadian exchanges are proportionately smaller than US exchanges and many firms are thinly traded small stocks. Additionally, there are different capital gain tax laws in Canada. These factors may affect the way investors react to stock split events. Over a period not covered by previous studies (1985 to 2000), the presence of positive abnormal returns following stock split announcements by Canadian firms listed on the Toronto Stock Exchange (TSE) is tested. Then, the authors try to explain the market reaction (if any) using signaling and attention hypotheses.

Results indicate that Canadian markets react positively to stock split announcements. On average, firms splitting their stock record a 1.76% positive and significant abnormal return on the announcement date, and 1.14% on the following day. An earning prediction error of about 115.05% after the split is also observed. This validates signaling hypothesis, which states that firms split their stock to signal superior earnings. However, the authors are unable to validate attention hypothesis in Canadian markets. The

THE RATIONALITY OF THE COLOMBIAN EXCHANGE MARKET

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ABSTRACT

This research analyzes the way agents participating in the Colombian exchange market form their expectations and how they arrive at an equilibrium price. The forward exchange rate was used as an approximation of the expected spot rate, implying the necessity to explain how its price is determined. Monte-Carlo techniques and three tests of the Forward Foreign Exchange Market Efficiency Hypothesis are conducted. Six hypotheses of behavior were tested, from static to rational expectations and from risk neutrality to risk premium and/or transaction costs. Weekly data from January 1997 to January 2006 presented signs of rational and adaptive expectations, together with risk neutrality.

INTRODUCTION

The tendency to promote a prosperous environment aimed at economic growth has become more pronounced during the last few years as worldwide economic integration has become consolidated. A series of events has confirmed this issue, such as the signing of commercial, scientific and technological cooperation agreements and internal norms being brought into line with international ones.

Colombia opened its capital account and reduced import barriers during the early 1990s. During this same period, the Banco de la República (BR), the country's monetary regulating authority, authorized exchange-rate cover operations for the Colombian peso - US dollar. By doing this, the BR tried to reduce exchange rate volatility and protect market participants.

Forward foreign exchange contracts involve two parties who agree to conduct transactions in foreign currency at an agreed exchange rate for a specified amount at some agreed future date. A forward contract eliminates the effect of future fluctuations on foreign exchange transfer rate. The forward exchange rate is calculated by using the current exchange and interest rates for both currencies and the contract maturity. Fulfilling the covered and uncovered parity condition of interest reveals a close relationship between spot and forward rates. If the Forward Foreign Exchange Market Efficiency Hypothesis (FMEH) holds under the assumption that agents have rational expectations and are neutral towards risk, the forward rate is an unbiased exchange rate predictor corresponding to the date of a contract's maturity. Thus the information contained in the agreed rate in the contracts for future delivery could be useful for predicting fluctuations in the Colombian exchange rate.

This study tries to determine whether some relationship exists between Colombia's forward and spot markets, assuming the rational behavior of agents participating in the exchange market and considering the implicit risk in forward contracts. Therefore, this article could be useful for those who participate in the exchange market or can be directly or indirectly affected by its dynamics. Market participants might use the information contained in the forward exchange rate for their own benefit without becoming involved in problems associated with drawing up complex prediction models and handling a wide-ranging database.

A COMPARISON OF PORTFOLIO PERFORMANCES OF THE RANDOM AND STRATEGIC STOCK SELECTION STRATEGIES: THE HAMPTON ROADS STOCK PICKING CONTEST

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ABSTRACT

In this paper the performance of the random and the strategic stock selection approaches are compared and tested to determine which results in the greater level of returns to a portfolio of stocks of Virginia based companies. The analysis is conducted via a stock picking contest developed by a local daily newspaper in the Hampton Roads area and hosted by a local university business school. The contest included 1,225 entries, in which contestants chose five stocks from Virginia-based companies. The portfolio return performance of contestants was observed over a 12 week period and the contestant receiving the greatest hypothetical returns over the contest period received a \$1,000 US savings bond. The stocks selected by contestants were classified into two aggregated portfolios, indicating whether a random, or a technical/strategic method, was used to pick stock portfolios. A comparison of the two aggregated portfolios indicated that the technical/ strategic selection group out-performed the random walk selection group. In 10 of 12 weeks of the contest the researchers observed a statistically significant difference in the returns of these portfolios. It was also observed that the strategic group out-performed the selected population of Virginia based companies. None of the aggregated average returns from the random or the strategic selection group portfolios out-performed the Standard & Poors 500 Average during the contest.

INTRODUCTION

There are well established theories of how stock prices and stock price changes are determined. Investors who believe markets are perfectly efficient and that investors are rational profit maximizers, would have no need to perform analysis. Most fundamental analysts assume that financial markets are efficient or mostly efficient. They believe that all stocks are correctly priced and opportunities to earn abnormal or excess profits do not exist. For the fundamentalists, stock prices reflect the fundamental economic health of the firm. As such, fundamentalists are likely to analyze the firm's profit, growth, and cash flow prospects in order to determine a fair price for a company's stock. Any information that impacts these fundamental economic elements are likely to impact the firm's stock price as well. Since such changes occur randomly and information about such developments arrives in the market randomly, stock prices are likely to change in a random manner. Hence, price changes follow a random walk according to Fama, (1965).

However, it is also argued that knowing the magnitude or direction of the change in price at period t , will provide information to allow prediction of the magnitude or direction of the change in period $t + 1$. Technical or trend analysts look beyond the firm's economic indicators for elements that influence stock prices and changes in stock prices. As a group they tend to accept the idea that markets are efficient. However, they believe stock price changes follow certain patterns and that such patterns can be discovered and exploited. They devote much effort to developing charts of market activity usually centered around price and volume behavior. Background information on these theories can be found in the works of Malkiel (1989) and Hilsenrath (2004). It is generally assumed that all investors are rational

MARKET SECTOR REACTIONS TO 9-11: AN EVENT STUDY

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ABSTRACT

This study presents an overview of how stocks believed to be most vulnerable to the 9-11 attacks reacted, in particular, in the pre-event period. The insider information theory about pre-knowledge of the attacks is carefully analyzed in both the airlines and the financial services sectors of the market. Standard event study methodologies are used to calculate abnormal returns before and after the attacks. Also, risk-adjusted returns are examined to determine whether investors achieved differential performance during the event period. Expectedly, significant negative excess returns occurred in the airlines and financial services sectors due to the incident. A subsequent reversal of excess returns indicates that markets may have overreacted to the attacks. Uncertainties in energy supply resulted in high but short-lived oil prices. Pre-event negative excess returns in airlines and financial stocks are suggestive of a trading pattern that may have been driven by expectation of an impending anomaly.

INTRODUCTION

The 9-11 attacks were a series of coordinated terror attacks in the United States on September 11, 2001. The attacks caused considerable disruptions to the U.S. economy as well as the financial market system. Following the attacks, the broad-based S&P500 index fell by more than 10 percent. The European markets suffered as well. In London, the FTSE 100 lost about six percent while the DAX in Frankfurt closed down 8.5 percent. Both the CAC 40 in Paris and the Swiss Market Index lost more than seven percent of their values. The attacks also revealed the vulnerability of the US financial infrastructure. The stock markets were closed for four days while bond trading was suspended for two. As well, there were significant disruptions in the clearing and settlement systems for government and many other financial assets. Investors seeking safe havens in a time of uncertainty bid up gold and crude oil prices.

It was also apparent that the nature of the attacks caused investors to permanently reassess their market risk perception. Graham and Harvey (2002) explain that the initial reaction of investors was to reduce profit projections by increasing the discount factor for future profits. Drakos (2004) and Straetmans et al (2003) agree, pointing out that total investment risk, in particular in the airline industry, rose substantially after the attacks. Ito and Lee (2005) note that the negative demand shock in the airline industry appeared to persist and could not easily be explained by economic or seasonal conditions.

Anecdotal evidence suggests that trading in the stocks of American Airlines (AMR) and United Airlines (UAL) rose markedly just before the attacks. According to the Bloomberg Financial News, shortly before 9-11, short put option positions in the stocks of Morgan Stanley Dean Witter and Merrill Lynch – both of which were housed in the World Trade Center – were more than 25 times their usual volume.¹ After the attacks, authorities in the US, Europe, and Japan launched an investigation to determine whether any of these trades were on account of the impending attacks. These investigations have so far proved inconclusive.²

FOREIGN DIRECT INVESTMENT IN LATIN AMERICA: A PANEL REGRESSION STUDY

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ABSTRACT

Since the early 1980s developing countries have generally experienced a heavy influx of foreign capital, and among the developing regions, Latin America has emerged as a prime destination of FDI. An extensive literature has evolved on the inflow of FDI in Latin America, which identifies a number of variables, such as market size, trade openness, etc., as the key determinants of FDI. Due to non-availability of reliable and consistent data, domestic investment climate as a determinant of FDI has been generally excluded from the literature. This study seeks to fill that void by using the Economic Freedom Index, published since 1995 by The Heritage Foundation, as a proxy for domestic investment climate for a sample of 18 Latin American countries over 1995-2004 period. Employing panel regression methodologies, this study finds that economic freedom is a significant and robust determinant of FDI in Latin America. This study also finds that NAFTA has created an insignificant locational advantage for Mexico vis-à-vis other countries in the sample.

INTRODUCTION

Development economists generally concur that the inflow of foreign direct investment (FDI) can play a vital role in the growth dynamics of developing economies. The literature generally accepts that the inflow of FDI in developing countries can help fill at least three “development gaps” – first, the “investment gap” by providing capital for domestic investment; secondly, the “foreign exchange gap” by providing foreign currency through initial investments and subsequent export earnings made possible by the initial investments; and finally, the “tax revenue gap” by generating tax revenues through additional economic activities (Smith, 1997). The FDI inflow can also create many other benefits for recipient economies. For example, FDI can help generate domestic investment in matching funds, increase local market competition, create modern job opportunities, increase global market access for locally produced export commodities, facilitate transfer of managerial skills and technological knowledge from developed countries, etc. -- all of which should ultimately contribute to economic growth in host countries.

Recognizing the manifold benefits of FDI, developing countries have generally eased restrictions on the inflow of foreign capital since the early 1980s. Furthermore, the end of the Cold War in the early 1990s brought about a new political era that not only witnessed the end of the foreign aid programs sponsored by the erstwhile Soviet Union in socialist LDCs (less developed countries), but also diminished strategic alliances between the US and the pro-US developing nations resulting in a sizable reduction in the US-sponsored foreign aid programs. The new political reality forced many LDCs to vigorously seek out alternative sources of foreign private capital. As a result, the annual FDI inflow to developing countries has increased manifold from \$23 billion (0.7% of their combined GDP) in 1990 to about \$211 billion (2.6% of combined GDP) in 2004 (World Bank, 2006).

The vital role played by FDI in the growth dynamics of developing countries has created considerable research interest among development economists. Consequently, a sizeable empirical literature has evolved on the determinants of FDI. These studies have identified a number of variables, such as market size, economic openness, financial liberalization, rate of return, quality of infrastructure, human capital, political instability, etc. as key determinants of FDI. However, due to non-availability of reliable and consistent set of quantitative data on investment climate, the literature has generally excluded the domestic investment climate in recipient countries as a determinant of FDI. A few recent studies, such as

ECONOMIC GROWTH AND FINANCIAL SECTOR DEVELOPMENT

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ABSTRACT

This paper estimates an Odedokun-type “supply-leading” model of financial sector development (FSD) which incorporates both banking and capital market variables as potential drivers of economic growth. The current findings illustrate the impact on economic growth of various measures of FSD which includes basic intermediation services, as measured by M2 and money market mutual funds, and more advanced financial products such as stock market development and risk management services. The empirical findings in this study document an important shift from an exclusive reliance on basic banking services among emerging/developing countries towards an expanding role for the capital markets. An even stronger emphasis on the role of capital markets is documented for a group of advanced countries.

INTRODUCTION

Finding ways to stimulate economic growth is a topic of global concern. Financial sector development (FSD) can play either a leading role in economic growth or it may take a more passive role (derived demand) in response to expanding economic needs. In the very early stages of development causation often runs from economic development to FSD. This view has been labeled “demand-following”. On the other hand, as economic growth occurs the direction of causality may reverse and a “supply-leading” relationship develops. Here the efficiency gains associated with the intermediation process help generate continued economic growth. Thus, expanded FSD takes on a “financial sector broadening” dimension where consumers and firms, acting as both investors and borrowers, have more efficient access to basic intermediation service. Expanded access to financial services saves time and lowers transactions costs. Furthermore, the development of large scale financial intermediaries and the linkage of national markets drives information and transaction costs even lower. For example, Gertler (1988) and Levin (1997) show that financial intermediaries can reduce the cost of acquiring firm-specific information, leading to lower transaction costs.

According to Allen and Santomero (2001), at much more advanced stages of growth economic agents may demand increasingly sophisticated types of financial services such as innovative risk management products. By facilitating risk management, improving asset liquidity and lowering trading costs, financial intermediaries can encourage investment in higher-return activities (Obstfeld, 1994; Bencivenga and Smith, 1991; Greenwood and Smith, 1997). This is an example of “financial sector deepening”.

LITERATURE REVIEW

Using a model which includes a number of growth-determining variables, Odedokun (1996) analyzes the economic and FSD status of a number of less-developed countries over the 1965 to 1988 period. Odedokun confirms that FSD plays a supply-leading role in promoting economic growth. Furthermore, FSD has a more consistent and statistically significant positive relationship with economic growth than do the other variables in his model. Tsai and Wu (1999) divide financial development into endogenous and exogenous components. Endogenous financial development results directly from economic growth. As an economy grows the aggregate demand for goods and services increases. To expand output, producers must look for efficient ways to raise capital. Consumer, on the other hand, will seek more efficient means to earn higher rates of return on their savings. Consequently, a more efficient financial market is required

A TRADING RULE TEST USING STOCKHOLM AND U.S. CROSS-LISTED SECURITIES

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ABSTRACT

This paper examines the relative efficiency of the U.S. and Stockholm Stock Exchanges. Numerous stocks are cross-listed on United States Exchanges and the Stockholm Stock Exchange. We compare the prices of these firms at near-simultaneous trading times. This study is an extension of an earlier work by Jalbert, Moritz and Stewart (2005), who completed an efficiency test on stocks that are cross-listed on the Stockholm and a U.S. stock exchange, finding evidence of an inefficient market. This paper extends this line of work by conducting a trading rule test to provide additional evidence regarding the efficiency of these markets. The results provided here offer additional evidence of efficiency problems between these two markets.

INTRODUCTION

If pricing differences exist between two markets which trade identical goods, there may be an opportunity to earn an arbitrage profit by selling short in one market and buying to offset the short position in the second market. Previous research has provided evidence that pricing differences sometimes exist between identical securities which are cross-listed on the Stockholm Stock Exchange and a United States Stock Exchange. In this paper, this line of literature is extended by developing and testing trading rules designed to take advantage of these previously identified pricing differences. The evidence here suggests that profitable trading rules can be developed. These findings provide additional evidence to suggest efficiency problems exist between these two markets. The remainder of the paper is organized as follows. Previous literature is examined, followed by a discussion of the data used in the analysis. Next the results are presented and discussed, followed by some concluding comments.

PRIOR RESEARCH

Various studies have considered the relationships between cross-listed shares, with a specific focus on the efficiency of the prices of the two markets. Fisher (1996) first developed the technique of examining serial autocorrelation to test for market efficiency. In this framework, the existence of persistent serial correlation indicates the ability of historical returns to predict future returns. The presence of this type of price predictability is viewed as a violation of weak-form market efficiency. The approach developed by Fisher (1996) has subsequently been used in a plethora of studies, many of which have found significant autocorrelations and cross-autocorrelations. Boudoukh, Richardson, and Whitelaw (1994) provide a summary of some of this work. They attribute these correlations to either 1) market frictions, 2) time-varying economic risk premiums, or 3) market inefficiencies caused by under- and over-reactions to new information. They examine the autocorrelations of futures returns and returns on the underlying spot index of small-firm-weighted portfolios. They conclude that nonsynchronous trading and market frictions are the primary cause of the observed autocorrelations. They argue that frictions caused by nonsynchronous trading have not previously been given enough credit as a source of such autocorrelation.

Jensen (1978) utilized profits from trading rules as an alternative method for testing for market efficiency. This approach compares the returns associated with a specified trading rule to the returns on a buy and hold strategy. The trading rule is based upon historical, publicly available information so that the

OPEN MARKET OPERATIONS AND THE PRICE OF LIQUIDITY: THE CASE OF THE CZECH REPUBLIC BETWEEN 1998 AND 2004

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ABSTRACT

Effective monetary policy depends on the ability of central banks to stabilize fluctuations of overnight interest rates around their policy rate. The function of the stabilization mechanism involves balancing aggregate bank demand for reserves with the central bank's supply of reserves in the interbank market. This paper discusses the main sources of temporal gaps between the demand for and the supply of reserves and their impact on overnight interest rate volatility. A theoretical explanation of the role of intertemporal substitution in periods of fluctuating reserves demand is provided. Crucial features of central bank targeting of overnight interest rates are discussed. The behavior of overnight interest rates in the Czech interbank market (1998-2004) is empirically examined in the context of excess liquidity. Some relevant structural changes in the interbank market are identified. Specifically, we find undershooting of the non-stability of excess liquidity in the interbank market and a sharp decline of overnight interest rate volatility associated with the introduction of intraday credit.

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I would like to thank the Ministry of Education, Youth and Sports of the Czech Republic for funding the research. The article is a part of a research project "Development of Financial and Accounting Theory and its Application in Practice from Interdisciplinary Point of View" registered by Ministry of Education, Youth and Sports under the registration number MSM 6138439903.

INTRODUCTION

Like the European Central Bank (ECB) and U.S. Federal Reserve System (Fed), the Czech National Bank (CNB) places a strong emphasis on the price of bank reserves traded within open market operations. In the case of CNB, the price of these highly-liquid resources is a fortnightly (bi-weekly) limit repo rate. This fortnightly repo rate acts as the upper limit of interest rates in banks bids for transient deposits of excess liquidity in daily CNB repo tenders.

Our previous study (see Brada, Bruna 2004) indicated that the actual level of the repo rate was, to a limited extent, a determinant of the dynamics of short-term interest rates in the Czech interbank market. The spread between the repo rate and interest rates may become relatively large while quantitatively significant deviations from the repo rate are a relatively long-term phenomenon. On the other hand, in ultra-short interest rates, overnight (O/N), seven day (7D) and fortnight (14D), the actual level of the repo rate seems to constitute a center of gravity that restricts fluctuations of these rates around the repo rate. This center of gravity limits potential deviations of ultra-short interest rates from the repo rate to be of transient character only.

The causes of different interest rate behaviors lie in the way CNB's involves itself in ultra-short maturity trading. CNB directly influences the price of the most liquid resources in the money market by announcing the explicit repo rate level. In addition, through repo tenders, CNB ensures an amount of liquidity for the banking sector that eliminates the existence of a longer-term deficits or excess bank reserves. Such deficits and excess could cause ultra-short interest rates to deviate significantly from the longer run repo rate.

NARROW PRICE LIMIT AND STOCK PRICE VOLATILITY IN EMERGING MARKETS: EMPIRICAL EVIDENCE FROM AMMAN STOCK EXCHANGE

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ABSTRACT

This paper empirically investigates the behaviour of daily stock return volatility around price limit hits for a sample of 159 (189) securities listed in Amman Stock Exchange (ASE), over the years 2003(2004). More specifically, we investigate whether daily return volatility for stocks that hit a price limit is lower (higher) in the post limit hit period than in the pre limit hit period. Such a finding would be consistent with the overreaction hypothesis, also referred to as the volatility spill over hypothesis. Our results indicate that stocks-hit experience their highest level of volatility on the day when stocks-hit reach their upper daily price limits of 5% (day 0), and decreases significantly one day after the hit. Similar results are found when stock hits reach their lower daily price limits of -5%, however with less magnitude. Results on the different sectors reveal that the banking sector experiences the highest volatility. However, when the stocks-hit reach its lower limit, the service sector shows the highest volatility as compared to the other sectors in the industry. Therefore, our results are more consistent with the overreaction hypothesis and that the price-limit technique is effective in reducing the volatility by providing a time-out to cool-off.

INTRODUCTION

Learning from the experience of stock market crashes, especially the Kuwaiti stock market (Al-Manakh) crash in 1982, and the black Monday stock crisis in October 1987 in the USA, the Amman Stock Exchange (ASE), like many other exchanges established a narrow limit on daily price movement to control volatility.

This paper empirically investigates the behaviour of daily stock return volatility around price limit hits for a sample of 159 (189) securities listed in ASE for the years 2004 (2005). Price limits set by the market establish literal boundaries where security prices are allowed to move within a trading day, thereby, provide a *cooling off* period. However, since price limits prevent one-day large price changes from occurring, they may cause price adjustments to spread out over a longer period of time. The absence of high liquidity in ASE may worsen information uncertainty and cause an increase in return volatility after the limit hit period when trading starts the next day. Therefore, daily return volatility for stocks that hit a price limit is expected to be lower (higher) in the post limit hit period than in the pre limit hit period according to the overreaction hypothesis (*volatility spill over hypothesis*).

This paper provides insight into stock market dynamics and systematic weaknesses, which will subsequently help us suggest certain reforms. It contends that price limits might not have the same effect across exchanges due to the marked differences in both market architecture and institutional characteristics. Markets can be organized as periodic call auctions, continuous auctions, or as continuous dealer markets. Most of the literature focuses on markets where trading takes place continuously or the market clears frequently during operating hours. This study, however, investigates the issue in a market characterized by thin trading, low liquidity, and the non-existence of different trading instruments and mechanisms.