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Relative Spread and Price Discovery

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Abstract

We establish the importance of relative minimum price increments for price discovery in the context of a single asset trading at diverse venues. Our model relates relative spreads to directed information flows and begets a set of testable implications. Although conventional wisdom dictates that futures prices lead equities, our model predicts the opposite should be true when particular relative price conditions hold for the bids and offers of each asset. We develop an empirical measure of price discovery which is suited to asynchronous, high-frequency financial data and test the model predictions. Empirical evidence strongly supports the relative spread mechanism.

Keywords: Market microstructure, market design, high-frequency trading.

JEL Classification: G12, G14.

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