Project Title
A long-run perspective on foreign exchange market liquidity

Project Abstract
The foreign exchange market is the world’s most liquid market. This project will compile a long-run foreign exchange data set of daily bid and ask spot and forward rates quoted in London over 1919-75. London was the pre-eminent forex market of the first half of the 20th century. This new data set will link with existing data sets from 1976 to the present and enable us to examine the behaviour of forex market liquidity over the long-run and across different exchange rate regimes. In addition, we will consider how currencies behave when subjected to systematic forex liquidity shocks given the large number of currency crises over this extended time period.

Activities and Achievement
The project began in July 2015 and we have just completed the data collection and cleaning phase on schedule. Procurement of additional funds from other sources has enabled us to go back before 1919 and gather data on bid-ask spreads during the gold standard period.

Next we will adopt a novel approach to the estimation of the three components of bid-ask spread in the foreign exchange market. The idea is straightforward. One can think of the bid-ask spread in general as a convex combination of the three components with their corresponding weights dependent on the prevailing monetary regime – fixed, floating and managed floating. For any given value of the weights, three regimes are sufficient to fully identify the three components. Hence, in a fixed exchange rate regime such as the pre-1914 gold standard and the post-1945 Bretton Woods period, volatility is effectively zero and market makers do not face inventory risk or information asymmetry, as long as the regime is truly credible. Thus, the estimated bid-ask spread during the pre-1914 gold standard and Bretton Woods only reflects the cost of dealing services. Deducting this estimate of dealing cost, we can then examine whether the remaining bid-ask spread in the foreign exchange market is mainly driven by inventory cost or adverse selection. In a managed floating regime with capital controls, such as the 1930s, foreign exchange transactions are restricted to the current account and currency speculation is effectively prohibited. The market is dominated by liquidity traders trading foreign exchange to pay for international goods and services (Sarno and Taylor (2001)) instead of insiders who speculate on currency movements alone. Therefore, the bid-ask spread after deducting dealing costs in this regime reflects the inventory cost facing currency dealers. Finally therefore, the remaining spread after deducting dealing and inventory costs in floating regimes can be attributed to adverse selection costs.

Dissemination
I intend to make an initial presentation of the data set at FTSE's World Investment Forum in Sea Island Georgia in May 2016
Outputs
   It is too early for any outputs
Major Difficulties and Any Other Issues
   None
Web Links
   none
Additional Information
Declaration
   This award has not yet produced any relevant outputs, but details of any future publications will be submitted to the CERF database as soon as they become available.
Signature - Main Award Holder
   1