Report Type

Mid Term Award Report

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Project Title

A long-run perspective on foreign exchange market liquidity

Project Abstract

We study the determinants of bid-ask spreads in the foreign exchange markets. The market microstructure literature argues that bid-ask spread arises due to dealing costs, inventory costs, and adverse selection. However, the literature has struggled to come up with an empirical strategy to identify the three determinants of the bid-ask spread as the measurement requires some inputs that are either non-observable or difficult to quantify. We adopt a novel alternative approach to the estimation of the three components of bid-ask spread in the foreign exchange market, exploiting the implications of exchange rate regimes. For example, in a (credible) fixed regime, bid-ask spreads are solely driven by dealing costs as market makers do not face inventory risk or information asymmetry.

Activities and Achievement

We expanded our dataset to maximize the coverage and continuity. Specifically, we collected daily spot bid and ask rates from the Financial Times for 1976-1990 for currencies unavailable from WM/Reuters for this period. We also collected daily bid and ask quotes for spot and forward rates from the Manchester Guardian for 1922-1924. Furthermore, we completed our dataset using spot and forward rates from other sources (BBI, Enzig, Keynes, Nelson Mark's webpage). Our main dataset now covers 19 developed country currencies from 1919-2016, and consists of 424,021 observations in the daily dataset and 13,879 currency-month observations in the monthly dataset (where there is no missing swap data).

In addition, we have defined exchange rate regimes using two alternative approaches. The first approach is to indicate regime using existing sources (e.g., League of Nations, Reinhart & Rogoff, Crafts & Fearon, etc.). The second approach exploits the statistical restriction that when two currencies, i and j, are both pegged to the same anchor, the cross rates between i and j have zero variance. We will then examine the impact of exchange rate regimes and regime changes on the returns and risks of currency trading strategies using regime-based decomposition of the relevant quantities.

Dissemination

Now that we have finished cleaning the new data set, we are turning our attention to producing a first draft of a working paper

Outputs

Now that we have finished cleaning the new data set, we are turning our attention to producing a first draft of a working paper

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