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A study on foreign exchange dealers' bid–ask spread quote behavior[☆]

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ABSTRACT

Based on a questionnaire surveying dealers in the Taipei inter-bank foreign exchange market that was conducted in March 2001, I attempted to answer the question of who initiated the wider currency spread. It was found that the risk-averse dealers of small banks quoted wider spreads in order to conceal their inferior positions regarding information and inventory or to avoid market volatility risk. Some of the dealers of large multinational banks in major financial centers who normally quote conventional spreads were found to quote wider spreads in response to the request for quotations by small Taiwanese bank dealers who widened their spread quotes.

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1. Introduction

Foreign exchange dealers set conventional spreads and fear that widening spreads in a turbulent market might damage an equitable and reciprocal trading relationship, their market image, and potential trading opportunities. Non-conventional spreads can drive away potential trading opportunities and the dealers' ability to read the market. This is confirmed by a series of recent questionnaire surveys involving foreign exchange dealers in three East Asian financial centers, the U.S., and London foreign exchange markets by [Cheung and Wong \(2000\)](#), [Cheung and Chinn \(2001\)](#), and [Cheung et al. \(2004\)](#). In addition, studies performed by [Bollerslev and Domowitz \(1993\)](#) and [Huang and Masulis \(1999\)](#) have found that while market competition increased when large multinational bank dealers' market shares increased, bid–ask spreads consequently declined.

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By contrast, *Bollerslev and Melvin (1994)* found that an overwhelming majority of quotations involved a shift in the spread from previous quotations in Reuters FFX banks' quotation data. A growing body of literature on the microstructure of foreign exchange markets suggests that foreign exchange dealers adjust bid–ask spread quotes to change inventory carrying costs at market close (for example, *Boothe (1988)*, *Bessembinder (1994)* and *Jorion (1996)*), avoid transaction risk (*Glassman (1987)*, *Bessembinder (1994)*, *Bollerslev and Melvin (1994)*, *Wei (1994)*, *Goodhart and Payne (1996)*, and *Louis et al. (1999)*), reduce overnight inventory risk (*Chakrabarti (2000)*), compensate for adverse selection costs (*Perraudin and Vitale (1996)* and *Bossaerts and Hillion (1991)*), avoid adverse selection at market open (*Naranjo and Nimalendran (2000)*, *Payne (2003)*, and *Bjornnes and Rime (2005)*), and affect trading volume (*Glassman (1987)*, *Bessembinder (1994)*, *Hartmann (1999)*).

How do we reconcile these two strings of seemingly inconsistent findings? If dealers fear that widening spreads might drive away potential counterparts and continue to quote conventional spreads even in turbulent periods, then who initiates non-conventional spreads, and why? Why have so many authors found that dealers have changed their quoted spreads on many different occasions?¹

Why then do small bank dealers frequently widen spreads? *Bollerslev and Domowitz (1993)* pointed out that risk-averse smaller bank dealers need to widen their spreads to control inventory at the end of their regional trading hours as well as to avoid trading losses due to their inadequate information on market order flow at the day's opening. In this paper, I discover that local bank and foreign bank dealers in Taiwan who deal with dealers in other major markets are inclined to quote wider spreads when important news is disclosed and market risk increases. The trading sizes are considerably small for local bank and foreign bank dealers in Taiwan compared with major bank dealers in other financial centers.

Goodhart and Figliuoli (1991) reported wider spreads emanating from countries in the Far East at the beginning of European trading hours. Why do dealers in countries in the Far East quote wider spreads at the beginning of European trading hours? This is no doubt because those small bank dealers in the countries in the Far East eagerly square their overnight positions at the end of regional business hours which is also the beginning of European trading hours. They quote wider spreads in order to avoid receiving unwanted positions or revealing information on their own unfavorable positions. The evidence of this study indicates that when trading with dealers in other major financial markets, local bank and foreign bank dealers in Taiwan are inclined to quote wider spreads when important news is disclosed and market risk increases.

The foreign bank dealers in Taiwan widen spreads when price volatility is high or when their counterparts widen their spreads which may signal possible market price changes or unknown information. Those dealers of larger banks, who normally quote conventional spreads, also widen spreads when trading with small banks that quote non-conventional spreads in order to accommodate the induced inconvenience and increased trade frequency involving smaller trades. Consequently, large multinational bank dealers in major financial centers will quote wider spreads in response to the request for quotations by small (Taiwanese) bank dealers who widen spread quotes. This inference agrees with *Goodhart and Figliuoli's (1991)* finding that some of the larger spreads emanate from Far East Asian dealers during the European trading time. *Cheung et al. (2004)* reported that 16% of dealers in London quote non-conventional spreads when trading with ill-informed and small banks. The number is even higher in Taiwan, for about 32% of dealers widen spreads when trading with small banks.

Consequently, our arguments reconcile the dealers' widening spread behavior from time to time in a large number of empirical studies with the dealers' intentions of maintaining the conventional spreads even in turbulent periods in survey studies such as *Cheung and Wong (2000)*, *Cheung and Chinn (2001)*, and *Cheung et al. (2004)*.

¹ For example, *Admati and Pfleiderer (1988)* suggested lower spreads during periods of high market activity. *Subrahmanyam (1989)* found that more trading by informed risk-averse participants brings about higher costs and hence larger spreads during periods of increased market activity. *Wei (1994)* indicated that the bid–ask spread increases as the market's perception of the volatility increases. *Bessembinder (1994)* concluded that the increase in spreads before weekends and holidays can be fully explained by the increased sensitivity of spreads to risk and liquidity costs over nontrading intervals. *Bollerslev and Melvin (1994)*, *Lyons (1995)* and *Jorion (1996)* argued that dealers tend to widen bid–ask spreads in order to compensate for the increased risk attached to inventory when exchange rate volatility is high. *Naranjo and Nimalendran (2000)* found that unexpected central bank intervention increases the adverse-selection costs and hence widens the bid–ask spread. *Bjornnes and Rime (2005)* found that adverse selection is responsible for a large proportion of the effective spread from four large Scandinavian bank dealers.

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