

Local information in foreign exchange markets

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Abstract

This study shows that order flow in a foreign exchange market appears to have permanent price impact only if it comes from certain regions. These regions are – as predicted by the local information hypothesis – centers of political and financial decision making. It is revealing that orders from other regions only show a very short-lived but no permanent price impact. Local information is so important that it carries over from the usually considered market orders to aggressively priced limit orders too. The finding is robust to common news shocks, to the consideration of feedback trading and to further controls.

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1. Introduction

In light of the failure of the traditional macro approach in exchange rate modeling the microstructure analysis of currency markets seems to provide new insights (see e.g. Frankel and Rose, 1995; Lyons, 2001; Sarno and Taylor, 2002). In a sense, it reverses the conventional top down macro perspective by analyzing trader behavior bottom up. Assuming that market participants are asymmetrically informed, it seems worthwhile to analyze behavior at the microstructure level in order to better understand who has information and in which way this information gets into prices. One plausible source of information advantage could be local proximity to centers of decision making. Goodhart and Figliuoli (1992) “regard it as inevitable that some aspects of news [in foreign exchange] will differ between geographical locations”. Obviously,

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an analysis testing the potential price impact of local information requires transaction data where currency orders can be linked to locations. This paper is the first, due to a new data set, that is able to examine this question exactly. We find clear evidence supporting the notion of local information advantage in foreign exchange markets.

The possible existence of local information advantages in financial markets does not seem to be self-evident in times of the Internet and other modern instruments of communication. These instruments may nourish some skepticism and, indeed, enough studies demonstrate that investments in local assets are often based on home bias instead of an information advantage (e.g. [Huberman, 2001](#)). Nevertheless, the careful analysis of locally rooted information asymmetries has brought about overwhelming evidence during the last years that local information still exists, even in modern globalized markets. [Coval and Moskowitz \(2001\)](#) identify performance advantages of fund managers that invest in local firms, [Hau \(2001\)](#) shows that trading profits are higher for local equity traders, [Ivković and Weisbenner \(2005\)](#) find that local equity investments of individual investors earn higher risk-adjusted returns and [Malloy \(2005\)](#) demonstrates superior forecasting performance of analysts for firms within the analysts' region (see also [Bae et al., 2005](#)). So, local proximity to centers of decision making, such as firm headquarters, can provide an information advantage. Recently, [Berger et al. \(2006\)](#) have extended this line of research to monetary policy forecasting and find that Frankfurt-based analysts predict interest rate changes of the European Central Bank significantly better than others. Obviously, local information advantages do not only appear in stock markets but also in the domain of macroeconomic fundamentals which is of particular importance for foreign exchange.

In contrast to this strong evidence for equity and money markets, there is hardly any outright test of the local information hypothesis in foreign exchange. [Goodhart and Figliuoli \(1992\)](#) are the first to examine local information asymmetries in foreign exchange. They find some evidence that indeed price movements between centers, such as London and New York, show negative correlation in returns, indicating different information sets, whereas price movements within locations do not. [Peiers \(1997\)](#) compares the quotes of single banks analyzing potential price leadership in the mark/dollar market around interventions of the Deutsche Bundesbank. She shows that at least one German bank seems to be better informed than others (but there is no such effect for US interventions according to [Dominguez, 2003](#)). [De Jong et al. \(2001\)](#) extend this work, among other things by considering more banks, and find a slight tendency but no unanimous proof of a local information hypothesis. [Sapp \(2002\)](#) identifies different price-leading banks in the European and the US market, again without a clear relation to the location of these banks' headquarters. Whereas these studies are actually interested in potential price leadership of single banks, [Covrig and Melvin \(2002\)](#) disaggregate the yen/dollar market into Japanese and other quotes and find that Japanese traders lead the market under certain circumstances. So there is some first evidence in favor of the local information hypothesis, but all these analyses are limited by the fact that they have to rely on indicative quotes which differ from prices ([Danielsson and Payne, 2002](#)).

Therefore, it seems highly warranted to examine the hypothesis of a local information advantage in foreign exchange markets with better data. For this purpose, we can rely on the full record of orders in a modern electronic foreign exchange market, i.e. the Russian interbank Russian rouble/US dollar market. Fortunately, all orders can be linked unanimously to one of eight different regions in Russia. This allows a straightforward test of the local information hypothesis by applying the standard concept of price impact analysis ([Hasbrouck, 1991, 2006](#)). Accordingly, all kinds of microstructural effects, such as liquidity-induced price impacts, compensate each other and disappear over time – the only price impact that will be of permanent

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