

News announcements, market activity and volatility in the euro/dollar foreign exchange market

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Abstract

We study the impact of nine categories of scheduled and unscheduled news announcements on the euro/dollar return volatility. We highlight and analyze the pre-announcement, contemporaneous and post-announcement reactions. Using high-frequency intraday data and within the framework of ARCH-type models, we show that volatility increases in the pre-announcement periods, particularly before scheduled events. Market activity also significantly impacts return volatility as expected by the theoretical literature on the order flow.

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1. Introduction

The impact of information on the volatility of foreign exchange (FOREX) returns has been theoretically and empirically studied in several papers, e.g. Degennaro and Shrieves (1997), Andersen and Bollerslev (1998), Evans and Lyons (1999), Melvin and Yin (2000) and Cai et al. (2001). As stressed in the literature on market microstructure (see O'Hara, 1995), the 'information' variable includes both a public and a private component. Regarding the market microstructure of the FOREX, both public and private components are strongly related to currency market news announcements. The public component is made up of announcements which take place at fixed times (which we call scheduled public announcements), or at random times (unscheduled public announcements). Regarding private information, the most recent literature on the microstructure of exchange rates allows for two types of private information. Firstly, some market participants could have access to yet unreleased information by central banks or government agencies (i.e. payoff related private information in the terminology used by Lyons, 2001). Secondly, the notion of private information can be extended to include the so-called unrelated payoff information, i.e. private information that a dealer has regarding interim states of the market (for example, a dealer knows that another dealer is keen on selling a large euro/dollar position, which should depress prices in the short run). Because this second possibility is the most probable type of private information event in the FOREX market, private information is strongly related to order flow between traders and their customers.³

With respect to the previous literature on FOREX volatility about the impact of news announcements, the aim of this paper is twofold. Firstly, we analyze the impact of a more refined and extended set of nine categories of news announcements on FOREX volatility in the new euro/dollar market. Secondly, we investigate the volatility dynamics before, during and after scheduled and unscheduled news announcements. The contribution of our research therefore consists in assessing the previous results on the new euro/dollar market and extending these by distinguishing between the impact on volatility of scheduled and unscheduled news in three time periods centered around the release of the news, i.e. the pre-announcement, contemporaneous, and post-announcement periods. We focus more particularly on the reaction of volatility in the pre-announcement periods as this topic has not yet been dealt with extensively in the existing literature. Taking into account the specific features of public and private information, the news impact on volatility can take place both before and after the announcement. In the case of scheduled news announcements, volatility increases in the pre-announcement period could be due to anticipatory trades by dealers who open positions to profit from some personal beliefs, i.e. they hope that the actual news outcome will coincide with their forecast of the outcome. A post-announcement volatility increase can be attributed to heterogeneity of interpretations of the contents of the news, surprised reactions and closing of positions based on prior anticipations. On the other hand, in the case of unscheduled news announcements, an increase in volatility before the announcement is probably linked, as suggested by Degennaro and Shrieves (1997), to the presence of informed traders who exploit their privileged information.

The econometric analysis is performed on a high-frequency data set of 5-min regularly time-spaced FOREX euro/dollar quotes. The time period ranges from May 15 to November 14, 2001. Our database also includes the news headlines that were released on the Reuters news-alert screens. Regarding these news announcements, we consider a much larger set of

³ See Lyons (2001) and references therein for additional information and recent developments.

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