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Feedback trading and autocorrelation interactions in the foreign exchange market: Further evidence

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Abstract

This paper tests for presence of feedback trading, asymmetric behavior and autocorrelation linkages in several industrial and emerging economies' exchange rates, with respect to the US dollar, as well as the Euro. The issue is examined via the means of a GARCH-augmented feedback model for the period of 1990 to 2003. The empirical results indicate presence of feedback trading and/or asymmetric behavior in both types of economies' exchange rates but absence of such behavior in the Euro. Presence of asymmetric behavior implies that market traders rely on central banks to intervene so they can realize short-term profits. Furthermore, evidence of volatility persistence in several exchange rates implies inefficiency in those markets. Finally, there are instances where the first-order autoregressive parameter is positive and statistically significant in the exchange rates of both industrial and emerging economies but not in the Euro. For the latter currency, lack of asymmetric behavior and feedback trading implies a credible currency in the eyes of foreign exchange traders.
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1. Introduction

Some investors attempt to identify trends in past stock prices and base their portfolio decisions on expectations derived from such trends. Such behavior is termed feedback trading. Feedback trading can either be positive or negative and each type presents some

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concerns for every market participant. The concern about positive feedback trading is that it makes financial asset prices to overreact to new information and can be considered desirable or unpleasant. For instance, investors with positive feedback strategies can be regarded either as destabilizers (or noise traders) or stabilizers. The first could occur because their sales contribute to the fall of the market and their purchases add to market advances. Therefore, if such trading tends to destabilize economies, it can have a serious impact on the emerging economies and the benefits from the liberalization of their markets can be diminished. Moreover, in several instances such strategies generate volatility in returns and create bubbles which may lead to market crashes when they burst. The second possibility could take place if trades of such investors are related to changes in risk premiums or permanent price changes. Financial market liberalizations of emerging economies usually attract more and diverse investors, which results in market appreciations and more inflows of capital. Such trading represents an important aspect of the functioning of financial markets since it reduces the risk of market crashes and eases the flow of transactions among participants.

Negative feedback trading exists when investors 'buy low and sell high', that is, engage in selling stocks following price increases and in buying stocks following price declines. Negative feedback trading can be the result of profit-taking as markets advance or from investment strategies that specify a target wealth in a portfolio. In the context of the foreign exchange market, positive feedback trading exists when traders buy/sell after a depreciation/appreciation of the exchange rate, whereas negative feedback occurs when traders buy/sell following an exchange-rate appreciation/depreciation. Essentially, positive feedback traders tend to stabilize the currency since their strategies typically follow hedging opportunities and extensive use of stop-loss orders. By contrast, negative feedback trading tends to emerge from the traders' efforts to realize profit as the exchange-rate appreciates (or depreciates) thereby driving the exchange rate's value away from its long-run value. These situations can be plausibly assumed because since emerging markets have fully opened up their markets to foreign investors and, additionally, their returns have become more closely correlated with the returns of developed economies.

Another consequence of the presence of a sufficient number of feedback traders in the foreign exchange market is the autocorrelation of returns, which is related to the extent of predictability in the foreign exchange returns. Recent evidence suggests that autocorrelation patterns are present and are multifaceted, at least in stock markets [e.g., see LeBaron (1992), for such dependencies in US stock returns, and Campbell et al. (1993), on the relationship between trading volume and stock return autocorrelation]. Regarding the foreign exchange market, Allen and Taylor (1990) indicate that most traders consider trend patterns at least as relevant as the market fundamentals in the determination of exchange-rate expectations in the short run. Similarly, Frankel and Froot (1987) find evidence of extrapolative expectations and credit it to the use of trend chasing (or charts) by professional traders. Vitale (2000) finds that noise trading in the foreign exchange market may be used to exploit expectations and exchange rates in order to achieve an informational advantage and ultimately a profit opportunity. Finally, Laopodis (2004) finds evidence of noise trading in the foreign exchange markets of both industrial and emerging economies. A related issue concerns the degree of efficiency in the foreign

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