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Information sources, news, and rumors in financial markets: Insights into the foreign exchange market

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Abstract

This article presents empirical findings on collective information processing in financial markets. Results are based on a questionnaire survey with 321 traders and 63 financial journalists from leading banks and financial news providers in the European foreign exchange market. Rating each other as the most important information source, foreign exchange traders and financial journalists are engaged in a circular pattern of market information processing, in which trading participants and financial news services form an interdependent relationship. Recent developments in technology have profoundly changed the nature of reporting and the role of news media in the foreign exchange market. Traders rate the speed of news and its anticipated impact on other market participants as more important than its perceived accuracy. These findings may help explain the role played by rumors in financial markets.

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1. Introduction

Neoclassical economic models of financial markets assume that participants make decisions on the basis of all available information and that they use this information fully and in an unbiased way. Based on the assumption of rational market participants, the efficient markets hypothesis postulates that prices always fully reflect the available information (Fama, 1970; Jensen, 1978). In financial markets, rational decision making and market behavior are assumed to be natural and therefore not in need of explanation (Cosmides & Tooby, 1994).

Recent years, however, have seen the efficient market hypothesis challenged both theoretically and by a number of contradicting empirical observations (Shefrin, 2000; Shleifer, 2000). For example, Thaler (1992) contrasts the plethora of observable market "anomalies" to the rationality assumption, which supposes that market participants possess the magic ability to intuitively solve economic problems with which even economists struggle. In the foreign exchange market, a number of authors have observed that in contrast to the assumption of full and unbiased information processing, particularly in short-term movements of exchange rates, models based on economic fundamentals alone have not been successful (Flood & Taylor, 1996; Harvey, 1996; MacDonald & Taylor, 1992). For example, economic analysis of growth rates or of trade cannot predict most short-term exchange rate changes (Frankel & Froot, 1990), and such "rational" economic concepts as purchasing power parity are not seen as useful by foreign exchange traders themselves (Cheung & Chinn, 2001). The rational view proposed by neoclassical economics is also contradicted by Harvey (1996), who uses such phenomena as the existence of trading rules that reliably generate profits and the expectation biases evident in short-term exchange rate behavior surveys as evidence for the irrationality of market participants.

In addition to these challenges to the efficient market theory, such market practitioners as the infamous speculator George Soros (1987, p. 29) have observed that supply and demand in financial markets are not independent givens, but that they instead contain "participants' expectations about events that are shaped by their own expectations". Soros' theory of reflexivity stresses the interdependency between the market and market participants' views. Approaches to markets which consider first- and even higher order beliefs of other market participants' beliefs often refer to Keynes' (1936) metaphor of the market as beauty contest, which suggests that market processes require an understanding not only of market participants' beliefs and expectations, but also of market participants' assumptions about other market participants' beliefs and expectations (Allen, Morris, & Shin, 2002; Morris & Shin, 1998).

How then is news and information processed in financial markets, and how do market participants decide on which information to base their trading decisions on? In the financial literature, a number of sophisticated attempts have been made to remedy the theory of information processing in financial markets. For example, Bikhchandani, Hirshleifer, and Welch (1992) examine the role of informational cascades in financial fads where it is optimal for the investor to simply follow the behav-