The Currency Market Information Edge

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The global foreign exchange (forex) market had an average daily turnover of $3.2 trillion as of April 2007, an increase of 69% from the previous year, according to the *2007 Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, conducted by the Bank for International Settlements. It is by far the largest financial market in the world, and its size and liquidity ensure that new information or news is disseminated within minutes. However, the forex market has some unique characteristics that distinguish it from other markets. These unique features may give some participants an "information edge" in some situations, resulting in new information being absorbed over a longer period. (For background reading, see the *Forex Tutorial*.)

Unique Characteristics of the Forex Market

Unlike stocks, which trade on a centralized exchange such as the New York Stock Exchange, currency trades are generally settled over the counter (OTC). The OTC nature of the global foreign exchange market means that rather than a single, centralized exchange (as is the case for stocks and commodities), currencies trade in a number of different geographical locations, most of which are linked to each other by state-of-the-art communications technology. OTC trading also means that at any point in time, there are likely to be a number of marginally different price quotations for a particular currency; a stock, on the other hand, only has one price quoted on an exchange at a particular instant.

The global forex market is also the only financial market to be open virtually around the clock, except for weekends. Another key distinguishing feature of the currency markets is the differing levels of price access enjoyed by market participants. This is unlike the stock and commodity markets, where all participants have access to a uniform price. (For more insight, read *Basic Concepts Of The Forex Market*.)

Market Participants

Currency markets have numerous participants in multiple time zones, ranging from very large banks and financial institutions at one end of the spectrum, to small retail brokers and individuals on the other. Central banks are among the largest and most influential participants in the forex market. However, on a daily basis, large commercial banks are the dominant players in the forex market, on account of their corporate customers and currency trading desks. Large corporations also account for a significant proportion of foreign exchange volume, especially companies that have substantial trade or capital flows. Investment managers and hedge funds are also major participants.

Differing Prices

Banks' currency trading desks trade in the interbank market, which is characterized by large deal size, huge volumes and tight bid/ask spreads. These currency trading desks take foreign exchange positions either to cover commercial demand (for example, if a large customer needs a currency such as the euro to pay for a sizable import), or for speculative purposes. Large commercial customers get prices from these banks that have a markup embedded in them; the markup or margin depends on the size of the customer and the size of the forex transaction. Retail customers who need foreign currency have to contend with bid/ask spreads that are much wider than those in the interbank market. (For more insight, see *The Foreign Exchange Interbank Market*.)

Speculative Positions Vs. Commercial Transactions

In the global foreign exchange market, speculative positions outnumber commercial foreign exchange transactions, which arise due to trade or capital flows, by a huge margin, although the exact extent is difficult to quantify. This makes the forex market very sensitive to new information, since an unexpected development will cause speculators to reassess their original trades and cause them to adjust these trades to reflect the new information. For example, if a company has to remit a payment to a foreign supplier, it has a finite window in which to do so. The company may try to time the purchase of the currency so as to obtain a favorable rate, or it may use a hedging strategy to cover its exchange risk; however, the transaction has to occur by a definite date, regardless of conditions in the foreign exchange market. On the other hand, a trader with a speculative currency position seeks to maximize his or her trading profit or minimize loss at all times; as such, the trader can choose to retain the position or close it at any point. In the event of new information, the adjustment process for such speculative positions is likely to be almost instantaneous. The proliferation of instant communications technology has caused reaction times to shorten dramatically in all financial markets, not just in the forex market. However, this "knee jerk" reaction is generally followed by a more gradual adjustment process as market participants digest the new information and analyze it in greater depth.

Information Edge

While there are numerous factors that affect exchange rates, from economic and political variables to supply/demand fundamentals and capital market conditions, the hierarchical structure of the forex market gives the biggest players a slight information edge over the smallest ones. In some situations, therefore, exchange rates take a little longer to adjust to new information.

For example, consider a case where the central bank of a major nation with a widely-traded currency decides to support it in the foreign exchange markets, a process known as "intervention." If this intervention is unexpected and covert, the major banks from which the central banks buy the currency have an information edge over other participants, because they know the identity and the intention of the buyer. Other participants, especially those with short positions in the currency, may be taken by surprise to see the currency suddenly strengthen. While they may or may not cover their short positions right away, the fact that the central bank is now intervening to support the currency may cause these participants to reassess the viability and implications of their short strategy. (For more on interventions, see *Profiting From Interventions In Forex Markets*.)

Example – Forex Market Reaction to News

All financial markets react strongly to unexpected news or developments, and the foreign exchange market is no exception. Consider a situation in which the U.S.

economy is weakening, and there is widespread expectation that the Federal Reserve will reduce the benchmark federal funds rate by 25 basis points (0.25%) at its next meeting. Currency exchange rates will factor in this rate reduction in the period leading up to the expected policy announcement. However, if the Federal Reserve decides at its meeting to leave rates unchanged, the U.S. dollar will in all likelihood react dramatically to this unexpected development. If the Federal Reserve implies in its policy announcement that the U.S. economy's prospects are improving, the U.S. dollar may also strengthen against major currencies. (For a related strategy, see *Using Interest Rate Parity To Trade Forex*.)

Conclusion

While the massive size and liquidity of the foreign exchange market ensures that new information or news is generally absorbed within minutes, its unique features may result in new information being absorbed over a longer period in some situations. In addition, the hierarchical structure of the forex market can give the biggest players a slight information edge.

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