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Foreign exchange customers and dealers: Who's driving whom?



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ABSTRACT

This paper tests the theoretical assumption of the foreign exchange market microstructure that dealers and non-dealer customers interact over discrete trading rounds. An exhaustive frequency-domain analysis reveals that the interaction is limited and mainly due to the instability of financial markets. The principal finding is that the trading activity of dealers is able to predict the customer order flow at low frequencies with wavelengths longer than roughly a week. In all, the evidence shows that non-financial customers are not as passive as some other research has suggested.

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1. Introduction

The portfolio shifts model by [Evans and Lyons \(2002\)](#) describes intraday trading in the foreign exchange (FX) market. It assumes that FX dealers and non-dealer customers interact and affect exchange rate formation over three rounds of trading. In the final round, the dealers set prices to encourage the public to trade and absorb dealers' inventory imbalances, whereas the dealers end the day with no net position. Hence, this setting views non-dealer customers as relatively passive market participants

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whose activity is consistent with liquidity provision. Similar arguments and empirical findings are documented in Bjønnes et al. (2005), Gradojevic and Neely (2008) and Gereben et al. (2006). Sager and Taylor (2006) refer to *passive customers* as those who are pulled into the market by favorable price movements where they exercise an “option to trade” once the price crosses their “strike price”.

In contrast to this view, Breedon and Vitale (2004), Corte et al. (2011) and D'Souza (2008) suggest that customers may in fact be more active, informed and present a source of information relevant for FX rate determination. Such *active customers* push prices by their buying or selling activity. In other words, they correspond to non-dealer market participants who trade in the first round of the portfolio shifts model. For example, Corte et al. (2011) devise a multi-currency trading strategy based on non-financial and financial order flows and demonstrate its superiority over the carry trade strategy. Also, D'Souza (2008) shows that dealers in FX markets provide intraday and overnight liquidity, while the activity of non-financial customers is more complex and somewhat interlinked with trading positions taken by other FX market participants. The relevance and informativeness of non-financial customer order flow is confirmed in a recent paper by Marsh and Miao (2012). Their results are consistent with the premise that corporate order flows contain dispersed information about fundamentals.

The goal of this paper is to determine whether non-financial customers act as passive market participants relative to FX dealers in the Canada/U.S. dollar market. More specifically, this work tests the robustness of the causal relationship between order flows generated by dealers and non-financial customers in both the time and frequency domains. As the bulk of the FX market microstructure literature concentrates on the order flow-price relationship, this analysis is unique in its focus and importance for the field. The data set spans 15 years of daily order flows for eight biggest currency dealers in Canada. This offers an unprecedented insight into the role of FX dealers and their potential impact on non-financial customers under various market conditions.

The findings first reveal the absolute absence of causality from customer order flow to interdealer trading, which implies that commercial customers are not push customers. Second, the causality from interbank trading to the customer-dealer order flow is non-existent in relatively stable markets and can only be observed over the 1998–2001 period. More specifically, the causality is present at weekly and longer horizons, but not in the very short run. This indicates that commercial customers are passive, long-run liquidity providers in times of market distress. A possible interpretation for this may be that during such periods FX dealers are better-informed and more knowledgeable in predicting long-run exchange rate movements than commercial customers. In this context, due to an increased uncertainty (and behavioral factors) commercial customers become reluctant to trade at longer horizons. This situation is consistent with an economic structure in which financial order flows are better informed and drive the exchange rate while commercial order flows respond to lower prices and provide liquidity (Gradojevic and Neely, 2008).

In Sections 2 and 3, the data and the methodology are briefly outlined. Section 4 discusses the findings and the final section concludes the paper with some suggestions for future research.

2. Data description

The data are recorded at a daily frequency and represent currency order flows (spot transactions in millions of Canadian dollars) for eight major Canadian commercial banks. The source of data is the Bank of Canada's FX volume report. This report is coordinated by the Bank of Canada and organized through the Canadian Foreign Exchange Committee (CFEC). From the Triennial Central Bank Survey (conducted by the Bank for International Settlements) perspective, the CFEC order flows represent approximately 40–60% of all Canada/U.S. dollar transactions. The time period is between January 2, 1990 and December 30, 2004, which is a total of 3715 observations.¹

The interest is in order flows with the following two types of counterparties:

- Commercial client transactions (CC) include all transactions with resident and non-resident non-financial customers.

¹ The Bank of Canada's FX volume report was canceled in 2005.

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