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Do FX traders in Bishkek have similar perceptions to their London colleagues? Survey evidence of market practitioners' views[☆]

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ABSTRACT

Do foreign exchange (FX) dealers from Kyrgyzstan, a low-income country, have similar perceptions to FX dealers from other international financial centers? Perceptions of Kyrgyz FX dealers in the interbank market are tested using detailed survey data against survey information from five major financial centers. The survey evidence finds that the FX dealers' responses from the Kyrgyz interbank market differ from those of other international financial centers. Stark differences arise in the perceptions concerning the effectiveness of central bank interventions and the influence of speculation.

1. Introduction

Do currency traders from a low-income country with a low level of financial development have similar perceptions about the influence of fundamentals on exchange rate movements to their colleagues from developed financial markets? The question's relevance stems from the common belief that currency traders in underdeveloped financial markets exhibit myopic behavior. One view is that uncertainty stemming from poor macroeconomic policy and a lack of central bank credibility is responsible for such behavior. Calvo and Reinhart (2002) provide indirect evidence using macroeconomic variables. They show that many emerging market countries resort to pegging strategies, despite counter claims by the countries' monetary authorities that the domestic currency floats freely. Currency traders in such an environment feel that

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(noisy) long-run fundamentals do not help them predict exchange rate trends. Another view emphasizes that short-sightedness stems from market structure. The microstructure view of exchange rates, advanced by Lyons (1995, 2001) and Evans and Lyons (2002), claims that currency traders are intermediaries that primarily redistribute incoming customer orders. According to this view, variables such as order flow or bid-ask spreads have a larger impact on exchange rates than do macroeconomic variables. If true, then large market spreads and exchange rate volatility in underdeveloped markets is explained by market structure (i.e., low liquidity, lack of derivate products).

The objective of this paper is to report findings from a foreign exchange (FX) survey that sheds light on whether currency traders from a low-income country have similar perceptions on the influence of fundamentals, speculation, and foreign exchange interventions for exchange rate movements to their colleagues from developed financial centers. FX surveys document the extent to which FX traders are heterogeneous in their beliefs and behavior and seek to uncover various links between the microstructure of the currency market and macroeconomic variables.[3] Perceptions of Kyrgyz FX dealers in the interbank market are tested using detailed survey data against survey information from five major financial centers: New York, London, Tokyo, Hong Kong, and Singapore. The comparative study also attempts to fill the empirical void on perceptions of currency traders in developing economies. We treat the FX traders' views from Bishkek, Kyrgyzstan as representative for an underdeveloped financial market and low-income economy (Kyrgyz GDP per capita was $376.8 in 2003 and $435.0 in 2004). By underdeveloped FX market, we mean that there are no forward markets, a high level of dollarization, customer driven FX transactions (i.e., low level of speculative activity), and a low level of financial participation in the interbank market. These properties of the Kyrgyz FX market are representative for FX markets in neighbouring CIS countries and many other developing economies, see BIS (2005), Melvin, Menkhoff, and Schmeling, (2008), and Scalia (2008).

The methodological framework in this study relies heavily on the questionnaires used in Cheung and Wong (2000), Cheung, Chinn, and Marsh (2000), and Cheung and Chinn (2001). The standardized questions used in these studies are adapted to the Kyrgyz market and allow us to compare the evidence on trading behavior between developed and less developed FX markets. The survey responses find that the perceptions of FX traders from Bishkek are not consistent with the trader's perceptions from New York, London, Tokyo, Hong Kong, and Singapore. We argue that stark differences in microstructure forces (i.e., market liquidity, asymmetric information, and market dominance) and macroeconomic outlook account for the heterogeneous views across less developed and developed FX markets.

The paper is organized as follows. The second section describes the survey's design. The third section provides background information on Kyrgyz FX traders. The fourth section confronts the empirical results for the Kyrgyz interbank market with stylized facts from previous studies for developed FX markets. Section fifth offers conclusions.

2. Survey design

The survey's design uses the standardized questionnaires from Cheung and Wong (2000), Cheung et al. (2000), and Cheung and Chinn (2001) as a starting point. This was done intentionally to facilitate the comparison of FX dealer perceptions between international financial centers. Because of specific institutional features of the Kyrgyz FX market, not all questions used in the studies by Cheung and Wong (2000), Cheung et al. (2000), and Cheung and Chinn (2001) apply. The adapted questions to the Kyrgyz market that highlight institutional aspects of the Kyrgyz market are discussed separately in the next section. These questions relate to microstructure issues focusing on the determination of bid-ask spreads, market dominance for select cross rates, and the speed of information dissemination.

The data for this study are obtained from mail-delivered questionnaires prepared by staff from the National Bank of the Kyrgyz Republic (NBKR) between June 2005 and September 2005.[4] The survey was conducted in an environment where the macro-economic conditions in the Kyrgyz Republic may be described as stable.[5] The period since 2001 has been characterized by successful macroeconomic stabilization, with further progress on structural reform, albeit at a pace slower than hoped.[6] Underlying growth has been stable at around 5% per annum and overall economic activity has diversified, with less reliance on agriculture and export sales to traditional trading partners. Inflation was reduced and sustained in the low

[3] FX surveys are an established tool used to identify the price setting process of foreign exchange traders, see Allen and Taylor (1990), Cheung and Wong (2000), Cheung et al. (2000), and Cheung and Chinn (2001), Gehrig and Menkhoff (2004, 2005) and Menkhoff (1998, 2001), and Taylor and Allen (1992). Their acceptance in the economics profession arose because of the empirical inadequacies of exchange rate models and the need to bridge the gap between concepts forwarded by academic economists and the day-by-day concerns of currency traders.

[4] The survey studies by Cheung and Wong (2000), Cheung et al. (2000), and Cheung and Chinn (2001) were conducted in the second half of the 1990s. Since then, survey evidence from the Triennial Central Bank Survey of Foreign Exchange and Derivates Market Activity 2005 show that FX markets have continued to expand. This means comparative differences between Kyrgyzstan and other financial markets are understated.

[5] The Kyrgyz Republic is a small, open transition economy. The main exports are gold and agriculture. In recent years progress has been made in alleviating poverty. Kyrgyzstan is among the more advanced transition economies in Central Asia in terms of market reforms. International Monetary Fund (2003) offers an overview of the Kyrgyz financial system.

[6] The Kyrgyz Republic has experienced three distinct periods of macroeconomic development since independence. The period until 1996 was characterized by macroeconomic instability, a common development in the CIS after the collapse of the Soviet Union. The period from 1996 to 2000 saw a resumption of growth and a decline in inflation. However, the large external shock owing to the Russian financial crisis in 1998 undermined these positive developments.