UNIVERSITEIT GENT

FACULTEIT ECONOMIE
EN BEDRIJFSKUNDE

TWEEKERKENSTRAAT 2
B-9000 GENT
Tel. : 32 - (0)9 – 264.34.61
Fax. : 32 - (0)9 – 264.35.92

WORKING PAPER

Spread Components in the Hungarian Forint-Euro Market

Michael Frömmel
Frederick Van Gysegem

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Spread Components in the Hungarian Forint-Euro Market*

Michael Frömmel, Ghent University, BELGIUM[a,b]
Frederick Van Gysegem, Ghent University, BELGIUM[a]

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Abstract

We apply the spread decomposition model by Huang and Stoll (1997) to a new dataset on the Hungarian Forint/Euro interbank market. In contrast to previous results we cover a minor market over a long time span. We find a significant inventory effect, which can be explained by the low number of trades per day and thus the long time between offsetting trades. The trading volume increased gradually during our sample period and coincided with a decreasing spread. We find that spread size increases significantly with trade size, in contrast to previous research on the customer market. We show that this increase is caused by rising inventory holding and adverse selection costs.

Overall this work confirms the predictions from various theoretical models on a small and less liquid market. When comparing with other results the size of the market, institutional differences between markets and specificities of a dataset seem to play an important role.

JEL: F31, G15

Keywords: microstructure, foreign exchange, spread, Hungary, inventory, adverse selection

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[a] Department of Financial Economics, Ghent University, W. Wilsonplein 5D, 9000 Ghent, Belgium
[b] Corresponding author: +32-(0)9-264-8979, michael.froemmel@UGent.be