Spread Components in the Hungarian Forint-Euro Market

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Spread Components in the Hungarian Forint-Euro Market*

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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 costs

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