

ASYMMETRIC INFORMATION AND THE CROSS-SECTION OF CURRENCY SPREADS

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This paper examines the cross-section of currency spreads using dealer transaction data. It has two main results: (i) dealers set larger spreads for smaller deals and (ii) dealers set larger spreads for importers and exporters than for asset managers and other dealers. Given the information structure of currency markets, these patterns are directly contrary to the predictions of standard models of market making under asymmetric information. The paper suggests two mutually consistent hypotheses to explain this. First, asymmetric information about general market conditions may provide dealers with market power relative to commercial customers. Second, dealers may strategically attempt to increase their access to information by quoting narrower spreads to privately informed financial customers.

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