

Liquidity, Volume and Informational Efficiency: Evidence from High-frequency FX data

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Abstract

Short-run return predictability from lagged returns and order flows is an inverse indicator of informational efficiency. This paper investigates the impacts of liquidity and volume on informational efficiency in the Yen/Dollar and Euro/Dollar markets. Using the high-frequency Electronic Broking Services (EBS) data, we find that the effect of volume on efficiency is positive, while that of quoted spread is negative. The decomposition of the spread reveals that the component associated with informed trades (the adverse selection component) is negatively related to informational efficiency. The evidence supports both the transaction cost view of liquidity and the asymmetric information view of the volume-efficiency relationship.

JEL classification: F31; G12; G14

Keywords: Liquidity; Volume; Informational efficiency; Order Flow

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