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Feature Articles

This month's focus: **"Foreign Exchange Margin Trading"**

In Japan, foreign exchange margin trading (FX trading) by individual investors is quite active, and the scale in terms of notional amount exceeds foreign exchange trading by banks and other financial institutions. Individual investors tend to prefer contrarian strategies and carry trades, and exert an influence on the interbank market when such trades are closed. The growth in FX trading also affects the business models of banks and other financial institutions, spurring an increase in electronification and prime brokerage. As a result, there is an increasing trend toward concentration of trading volumes among institutions. Given the current status of both the domestic and global market environment, there is scope for further growth in FX trading, which will increase its influence on the interbank market.

Foreign exchange margin trading (FX trading) in Japan has appeared parallel with the liberalization of foreign exchange trading which resulted from the 1998 revision of the Foreign Exchange Control Act enacted in the context of the Japanese version of the so-called financial Big Bang. This period overlapped the dawn of online securities brokers, i.e., the age in which close affinity between financial instruments trading and information technology (IT) was widely recognized among investors. In just 20 years, FX trading penetrated among non-professional Japanese investors as one form of derivatives trading. Japan's FX trading market has rapidly grown into the world's largest such market. This paper explains the current status and characteristics of Japan's FX trading market with a focus on market size, business models of FX trading business operators and their financial standing, investor trading methods and profit/loss status, etc., and control and regulation by laws or other means. In addition, the paper describes the situation where the FX trading market and interbank foreign exchange market coexist through provision of liquidity in Japan. While FX trading has been playing a pioneering role in over-the-counter (OTC) derivatives trading in Japan, unprecedented efforts that cannot be found in conventional business practices are now demanded to ensure further growth of FX trading as a product available for trading by the general public. Therefore, this paper concludes by pointing out some issues that need to be addressed for the development of FX trading in Japan.

This paper explores the behavior of emerging players in foreign exchange markets, namely Japanese retail investors whom are commonly called "Mrs. Watanabe". Using the data of foreign exchange margin trading on the Tokyo Financial Exchange, we find that they are momentum traders who pursue return from spot rate changes with a one to ten day horizon. Our paper provides evidence of Mrs. Watanabe having actively exploited profit opportunity from short-term fluctuations in exchange rates, not just holding a position generating carry return.