

An Investigation into the Existence of Exchange Rate Arbitrage in the Mombasa Spot Market

Abstract:

This study sought to investigate if exchange rate arbitrage existed in the Mombasa spot market. The study was conducted in a background of gains in information efficiencies, drastic reductions in information costs and increased market vibrancy. The study is descriptive in nature. The population in this study comprised all the banks and forex bureaus that were operational in Mombasa between January and December, 2010. Those included 26 banks and 14 forex bureaus. A census was conducted. The study covered 252 days in the year 2010. Analysis of both triangular and locational arbitrage opportunities was done. The findings showed that both arbitrages existed in the spot market but descriptive statistics indicated a comparative decline from earlier studies with comparative sums, means, counts and maximums generally declining. A decline of 59% on locational arbitrage frequencies was registered on Mule (2004). Further, declines of 64% on locational and 67% on triangular arbitrage frequencies were registered from Muhoro (2005). The results also indicated that triangular arbitrage presented more arbitrage opportunities than locational arbitrage. While the mean arbitrage was 147.1% higher, the sum was 52.7% greater and 291.8% more margins were realized. In addition, hard currencies that were more frequently traded including the US Dollar, Sterling Pound and Euro were more efficiently priced than hard currencies that were hardly traded including the Australian Dollar, Japanese Yen and the Canadian Dollar. This study therefore lent support to literature and studies that have identified market vibrancy, information cost reductions and greater proliferation of information as factors that lead to greater market pricing efficiency and less arbitrage opportunities. The study equally lent support to existence of pricing inefficiencies in the foreign exchange market that lead to exchange rate arbitrage opportunities.