EXCHANGE RATE ECONOMICS – LECTURE 2
THE MICRO APPROACH TO EXCHANGE RATES

1. What is "Microstructure" and How Does it Differ from Macro Approaches?

Focus on agents behavior and market characteristics

***heterogeneity: information, horizons**

***institutional constraints:**

market makers

liquidity traders

risk sharing

price discovery

Goods & asset market approaches empirical failures

***goods trade small fraction of FX market**

***asset markets move quickly in response to *expected* changes**

"news" quickly incorporated in price

expectations unobservable

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"Macro" vs. "Micro" Approaches to FX

***macro models focus on macro fundamentals and representative agents**

public info. moves market

all share same info.

***micro models focus on trading process and participants**

risk sharing ("hot potato" passing) generates pyramiding of volume

trades are informative

private info. conveyed

incomplete risk sharing

***no Walrasian auctioneer**

dealers don't see all orders

price quotes precede orders

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***macro models estimated at low frequency and include "fundamentals"**

public info. doesn't explain much

no "price discovery" of private info.

***micro models include order flow & inventory**

examine exchange rate between transactions

even with macro fundamentals included, order flow is important

fundamentals expectations in order flow?

***micro models have role for spreads that is missing in macro models**

may reflect information, inventory, uncertainty

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