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
"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

*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