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What does currency order flow tell about spot exchange rates of Asian emerging markets?

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Abstract

This study investigates the role of currency order flow in explaining the emerging Asian markets' exchange rates relying on linear and nonlinear modeling. The daily currency order flow of the US dollar relative to the nine important Asian currencies is constituted and explored with the respective exchange rates. First, we find that order flow affects the spot exchange rate positively for the sampled Asian currencies which indicates that the buying pressure of the US dollar depreciates Asian currencies. Second, the effect of order flow is asymmetric which explains that a surge and a fall in order flow have different effects on the exchange rate. This study unlocks the contribution of the market microstructure research where the asymmetries improve the power to explicate exchange rates. The nonlinear model forecasting performance validates this stance.

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Keywords: Currency order flow; Exchange rate; Asymmetric relationship; Market microstructure; Emerging markets

1. Introduction

The failure of traditional exchange rate models to empirically explicate and forecast exchange rates movements (Meese & Rogoff, 1983; Frankel & Rose, 1995) has led financial economists and international finance scholars to further research using analytical models that can better explain empirically the determination of exchange rates, as well as forecast exchange rate movements (Banti et al., 2012; Cerrato et al., 2011; Engel et al., 2008). Following this line of research, promising evidence has been provided by Evans and Lyons (2002) and the existence of a strong relationship

between exchange rate fluctuations and order flow has been theoretically and empirically demonstrated by Rime et al. (2010).

O'Hara (1995) describes the market microstructure method as "... the process and outcomes of exchanging assets under explicit trading rules". The trading process is centered on order flow. Therefore, order flow turns out to be pivotal in the microstructure approach (Frankel & Rose, 1995). The net buyer- and seller-initiated forex orders are described as currency order flow (Evans & Lyons, 2002). Thus, currency order flow corresponds essentially to what practitioners suggest as buying pressure or selling pressure. Furthermore, by testing its ability to transmit information concerning price formation, theoretical and empirical works have established that currency order flow has substantial explanatory power to describe exchange rate changes (Rime et al., 2010) such that changes in expectations move the order flow that successively influences the related exchange rate (Kleinbrod & Li, 2017).

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