

Strategic Behavior in Two-Sided Foreign Exchange Auctions

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Abstract

The market microstructure chosen for foreign exchange auctions can influence trading volumes and equilibrium exchange rates. With emerging markets and developing countries increasingly utilizing two-sided auctions, we show that the choice of the discrete "tâtonnement" mechanism creates incentives for strategic behavior among market participants. The theoretical arguments are supported empirically through analysis of detailed data from a rare example of a tâtonnement market, the Moscow Interbank Currency Exchange. Consistent with findings from experimental economics, new entrants altered strategic behavior mainly on the market's demand side, without comparable implications for the supply side. We also show that bids and offers were influenced by the opportunity cost of holding dollars, parallel market premia, and specific policy measures.

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