

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 19 November 2019, 13:00-17:00

SUMMARY OF THE DISCUSSION

1. Structural developments in the FX market

Vladyslav Sushko and Henry Holden (BIS) presented the main findings from the 2019 BIS Triennial Survey and Nick Crawford (Commerzbank) supplemented them with an analysis on structural developments in the FX market. The BIS FX Triennial Survey, which covers 1,300 reporting institutions in 53 countries, showed that global FX turnover had increased to USD 6.6 trillion per day. Swap and forward FX turnover had driven the increase in turnover, while the spot share had declined. Additionally, trading volumes had risen sharply with “other financial institutions”, a category that includes lower-tier banks, hedge funds and principal trading firms. Prime-brokerage volumes had recovered in tandem. The share of electronic trading between dealers and customers continued to rise with the growing use of algorithmic trading and trade execution across a large number of electronic venues by the more sophisticated FX clients.

The BIS also collected information on FX settlement for the first time, showing aggregate settlement risk had increased in absolute and relative terms since a 2013 survey conducted by CLS. The BIS Committee on Payments and Market Infrastructure and the Basel Committee on Banking Supervision had launched a joint action plan to reduce this risk, including supervisory reviews, industry engagement and data collection.

The analysis of FX market structural developments suggested that bid-ask spreads had tightened over the past three years, except for brief periods during and after geopolitical events. FX volatility had been on a downward trend and liquidity had improved, as market participants were able to trade larger quantities than previously the case at unchanged spreads. The number of flash events had declined substantially over the past two years compared to previous years.

During the discussion, members remarked that the various interpretations relating to declining bid-ask spreads and improved market liquidity could primarily be owing to recent stable market conditions and extremely low volatility. One member pointed out that should the low volatility environment persist, opportunistic non-bank market-makers could be forced to cut their market-making business due to strained profitability. Some felt that should this low volatility regime change, involving higher interest rates or increased geopolitical risks, the market dynamics could worsen. It was also observed that algorithmic market-making, whereby computer programs provide market quotes automatically, could lead to more liquidity gaps if several algorithms were to be suspended simultaneously in order to reassess fair market prices amid heightened volatility. Finally, it was further highlighted that liquidity tended to become more concentrated at specific times of the day (London opening, WM/R fixing at 16:00 GMT, New York opening), while at other times of the day liquidity declined, a feature which was particularly noticeable at month-ends.

2. FX Global Code and the Global Foreign Exchange Committee

The Group discussed the Global FX Committee's (GFXC) potential areas of focus for the three-year review of the FX Global Code (Code). To ensure that the Code remained fit for purpose, the GFXC committed to undertake a three-year review of the Code in 2020. The plans for the three-year review would be discussed at the GFXC meeting on 4 and 5 December 2019.

Simon Brunner (Credit Suisse) and Paul Clarke (Refinitiv) presented an update of the FX benchmarks with particular reference to the [Financial Stability Board's \(FSB\) 2014 report on Foreign Exchange Benchmarks](#). The analysis, which was conducted for major currency pairs, showed an overall improvement in FX benchmark execution since the FSB reports on several metrics: (i) the spike in trading activity that used to occur just before the fixing window had disappeared; (ii) the predictability in terms of performance drift during the window had vanished with volumes being more evenly spread out in the fixing window; (iii) a lower market impact from trades occurring during the fixing window could be observed compared to similar transactions outside of the fixing window; and (iv) a lower bid/ask spread was observed due to deep liquidity during the window.

The Group discussed the market's continued reliance on FX benchmarks, including their ties to bilateral contractual arrangements and index investing. There were further remarks about the consistency of FX benchmark calculation methodologies, the balance between buy and sell orders and the concentration of FX turnover in the benchmark window.

3. FX outlook – review of FX market developments and outlook

Alan Stewart (Goldman Sachs) reviewed the main FX market developments and initiated a group discussion on the FX market outlook.

The imposition of tariffs over the past 18 months could be regarded, economically, as equivalent to a negative supply shock with an adverse impact on both growth and inflation. The current and previous periods of US dollar strength had initially coincided with bouts of protectionism. The euro area macroeconomic outlook was uncertain with early indications that the slowdown in the manufacturing sector could spill over to the services sector. Despite this, the euro's relative attractiveness was slowly gaining ground as interest rate differentials to the US dollar narrowed. As a result, investor positioning in the US dollar may have peaked and could decline going forward. Emerging markets currently looked more resilient compared to previous years with strong aggregate performance in both equity and bond markets. The adverse developments in emerging markets that occurred this year had been idiosyncratic in nature with limited spillover effect.

Some members expected FX markets to remain range bound with low volatility in light of monetary policies in major countries being accommodative and were not expected to diverge considerably. Meanwhile, a few members remarked on the apparent contradiction between a fragile and uncertain global macroeconomic outlook, particularly in connection with some geopolitical risks, on the one hand and low volatility and high equity market prices, on the other. It was pointed out that investors were becoming increasingly sophisticated in allocating funds and were nowadays much less leveraged. This was expected to limit the potential for margin calls and the swift withdrawal of funds, thereby reducing risks for abrupt market movements. Investors' strong search for yield and carry were also expected to contribute towards mitigating risks of disruptive market developments.