EUROPEAN CENTRAL BANK

EUROSYSTEM

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Ad hoc teleconference of the ECB's Foreign Exchange Market Contact Group – 9 March 2020

Summary of the discussion

Members of the Foreign Exchange Market Contact Group reported that the foreign exchange (FX) market was functioning well overall amid the heightened stress conditions in financial markets and trading had for the most part been orderly. The bid-ask spreads of G10 currencies had widened overall, but dealers reported decent liquidity and platforms reported substantial volumes going through e-trading. Some mentioned a few pockets of illiquidity in less liquid currencies and commodity-linked currencies after the significant decline in oil prices.

There had been a short-lived USD/AUD and JPY/AUD flash event during the night before the teleconference (with falls of 4% and 6% respectively), but both currency pairs had largely recovered by the end of the Asian trading session. More generally, sell-side participants reported a reduction in risk appetite and inventory availability with investors seeing smaller order book depth, but overall platforms and market-making operations had both been working well and were resilient.

The demand and cost of US dollar funding in FX markets had increased following the oil price crash. This had led to a rise in premia, but not yet to market dysfunction. Short-term US dollar funding had been working reasonably well even though the market was seen as becoming more distressed.

Members highlighted various issues that could have an adverse impact on FX markets, including a sharper deterioration in FX volatility markets (FX options markets). In the last year systematic trading accounts had been regular suppliers and sellers of volatility (selling options) to earn additional income. This supply flow had dried up and dealers were now observing more buying, leading to a fundamental shift in supply-demand conditions which posed a risk to the functioning and liquidity of options markets. One member also highlighted that some traders had switched from electronic to voice trading for FX options, in order to be able to get deals done.

One generally voiced concern related to market functioning and liquidity was the degree to which market participants have staff working from home. This might lead to reduced market access among buy-side firms, with slower connections meaning slower quotes, which, in turn, risked lowering market liquidity. Sell-side trading was considered to be more resilient owing to the less frequent need to trade, its global reach and the fact that there were multiple trading venues. Increased latency (in particular for the buy-side) would also lead to higher reject rates, but this was considered normal in current circumstances. Not only could the dispersion of front office staff constitute a risk, but middle offices and back offices could also be spread across multiple locations, which could lead to a delay in the whole trade cycle and in any trade resolution process.