EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 24 September 2019, 10:00-14:00

SUMMARY OF THE DISCUSSION

1. Execution algorithms

Group members discussed the state of play and the main trends and developments in foreign exchange (FX) execution algorithms. An FX execution algorithm (algo) is an automated trading program that seeks to buy or sell a predefined amount according to a set of parameters and instructions with the objective of filling the order. Members of the Group also exchanged views on typical algo characteristics and their influence on market functioning.

The use of execution algos has grown considerably over the last few years, but differs substantially depending on jurisdiction, currency pairs and client sophistication. Algos were originally used to provide anonymity, in particular to avoid a large price impact when executing large orders. Users also wanted transparency in relation to internal execution policies, and the use of algos allowed improved control of trade execution. While the first algos were relatively simple, they have become increasingly complex over time and include features such as smart order routing, adaptive technologies and pattern randomisation. The most recent “fourth generation” algos feature real-time feedback on execution effectiveness and allow traders to make dynamic decisions throughout the execution lifecycle.

The key topics under discussion in relation to algos were responsibility, accountability and the treatment of algo malfunctioning. Some members underlined that, clients assume the risk for their execution performance when using algos in the FX market. A few members pointed to a lack of transparency regarding the inner algo mechanics and on algo providers’ organisational setups. However, other members stressed that, to eliminate conflicts of interest, banks typically have clear information barriers between their algo developer teams and market making desks. Clients’ knowledge of algos also varies significantly. Some market participants with more limited knowledge may feel constrained in asking their providers about algo functioning. On the other hand, some sophisticated clients are reportedly sending detailed questionnaires to their algo providers about algo design and order handling, while insourcing post-trade analysis from third parties.

Members also discussed algo behaviour in stressed market situations. One view was that algos were equipped to handle changing market conditions. A few other members suggested that, as they tend to have similar control structures, certain algo strategies could amplify FX market moves in stressed situations.

2. FX Global Code and Global Foreign Exchange Committee

The Group was informed about the work agenda of the Global Foreign Exchange Committee (GFXC). To ensure that the FX Global Code remains fit for purpose, the Committee had committed to undertake a review of the code every three years, with the first review in 2020. GFXC Chair Guy Debelle (Reserve Bank of Australia) explained via teleconference that rather than being a comprehensive overhaul of the relatively new code, the review would instead focus on selected issues. The GFXC would seek feedback through multiple channels and encouraged members of the

Foreign Exchange Contact Group to provide their detailed opinions on the review. The GFXC had also launched its annual survey of market participants, which gives respondents who are not member of local FX committees an opportunity to provide feedback on areas where they think greater guidance from the code may be necessary. Mr Debelle encouraged as many market participants as possible to take part. The next GFXC meeting will take place on 4-5 December 2019.

3. FX Outlook – Review of FX markets development and outlook

Stefanie Holtze-Jen (DWS Group) said in her outlook that she expected the FX market to remain range-bound and volatility to remain subdued, thus reflecting signs that the major economies are slowing down in a broadly parallel fashion while global central banks are acting to provide a supportive monetary environment. Members agreed that, in general, volatility in FX markets had remained low compared with the fixed income and equity markets but said that the currently high level of long sterling positions pointed to potential substantial volatility in the event of a no-deal Brexit. On the whole, emerging markets were weathering external headwinds better than in the same quarter last year. Significant capital outflows or currency weaknesses had generally been limited to idiosyncratic cases, such as Argentina or Turkey, or to those currencies most directly affected by escalating trade tensions, namely those of China and South Korea. This situation differed from August 2018, and was likely to stem from support provided by low and flat sovereign yield curves for advanced economy currencies, which had led to significant capital inflows into emerging markets this year.