FX: World's Biggest Market Pulls Back (A Little) At Last

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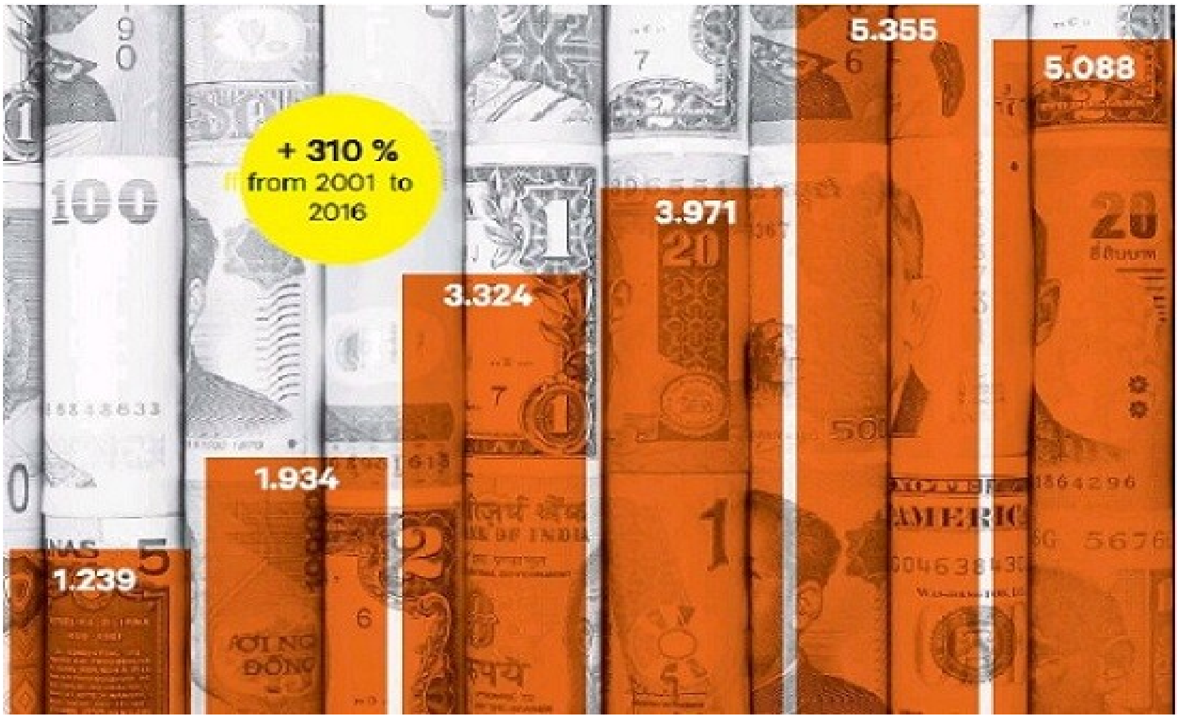
The daily turnover of global foreign exchange markets fell by 5.6% from April 2013, to an average US$ 5.1 trillion in April 2016, according to the recently published figures of the Bank for International Settlements' "*Triennial Central Bank Survey*". It is also the first time since 2001 that FX spot turnover has subsided.[1]



Naturally, exchange rate movements influence comparisons with previous surveys. In particular, the

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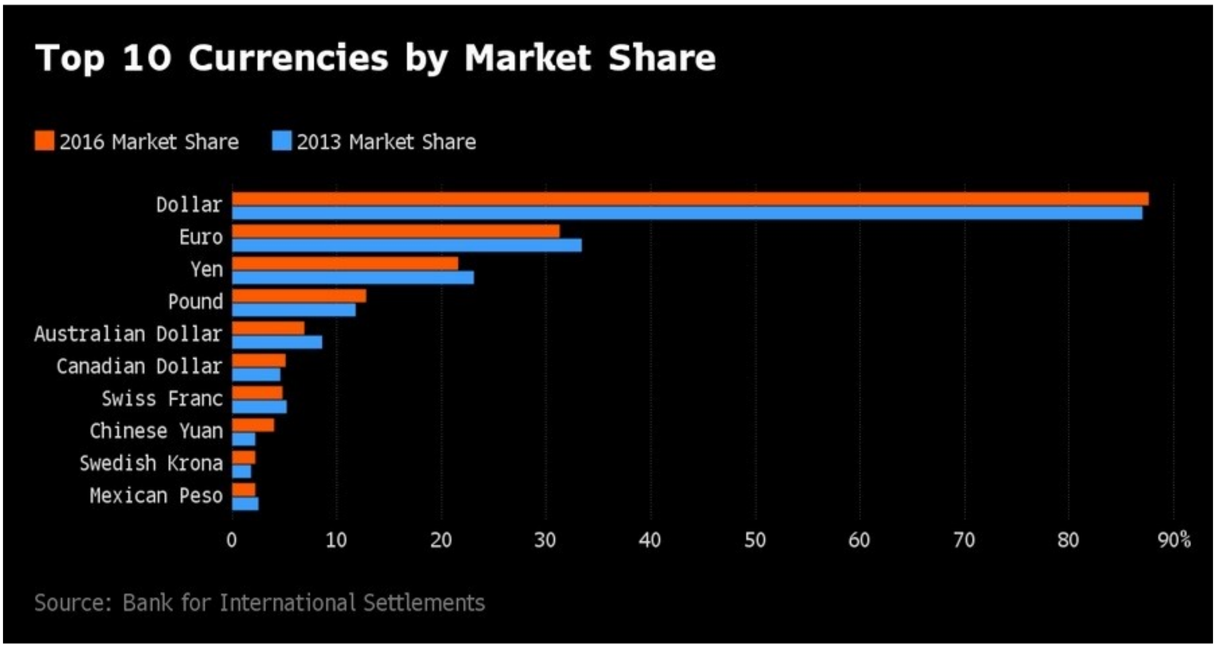
1 Spot market activity fell by 19% to US$1.7 trillion per day in April 2016. The 6% rise in FX swaps, averaging US$ 2.4 trillion daily (half of which were interbank trades), was not sufficient to make up for the smaller spot-market turnover.

appreciation of the US dollar between 2013 and 2016 reduced the USD value of turnover in other currencies. When valued at constant (April 2016) exchange rates, global turnover increased slightly, by about 4% between April 2016 and April 2013.

Nevertheless, the latest developments contrast with the strong growth in turnover observed between Triennial Surveys since 2001. Indeed, the previous decade had seen a continuous growth in the global size of the currency markets, with traded values increasing by nearly 400%, from US$ 1.1 trillion in April 2001 to US$ 5.4 trillion in 2013.

In any event, the US dollar extended its lead as, by far, the world's most traded currency, being on one side of 87.6% of all trades, with the euro coming a distant second, particularly after the Eurozone financial crisis, which saw Europe's single currency lose FX market share year after year. The euro's market share declined to 31% in April 2016 from 33% in April 2013, and 39% in April 2010 (see graph below).[2]



2 Turnover in the four most actively traded euro currency pairs – USD/EUR, EUR/GBP, EUR/JPY and EUR/CHF – fell. USD/EUR average daily turnover declined by $119 billion, while the relative declines were most pronounced for the EUR/JPY and EUR/CHF pairs

The opposite trend prevailed for emerging-market and Asian currencies, especially the renminbi, whose trade volume increased remarkably over the last decade and has now doubled its market share to 4%, thus becoming the world's 8th most actively traded currency, as well as the most actively traded emerging-market currency, overtaking the Mexican peso.

The rise in the share of renminbi was primarily due to the increase in trading against the US dollar. In April 2016, as much as 95% of renminbi trading volume was against the US dollar, and the USD/CNY pair became the 6th most actively traded in the world – up from the 8th position in April 2013 and only the 15th in April 2010.

London has lost ground as an international trading centre, particularly in the wake of the Brexit campaign, its share of global foreign exchange trading having fallen to 37% (from 41% in April 2013), although it remains isolated as the largest in the world. In fact, taken together, UK and US currency trading account for 56.5% of the entire world's FX turnover.

Asian trading centres are increasingly relevant to currency markets, led as ever by Singapore, but despite recent growth Asia's FX trading centres together still amount to no more than 24% of world turnover.[3]

The figures from the BIS survey show, once more, that the size of the international foreign exchange markets does not hold a direct relation with world economic activity. In four trading sessions FX markets transact a volume of resources equivalent to the value of the entire world trade (of both goods and services) in the whole of 2015.

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3 All the rest of the world combined represents only 20% of FX trading. On a side note, Geneva dropped from 6th to 8th place in the world ranking, while Paris has gained one position and Frankfurt remained at 9th place. Also, even though London lost FX market share, sterling trading increased its share from 5.9% in April 2013 to 6.4% in April 2016, before the results of the Brexit referendum were known.

The reduction in spot trading can be explained by several reasons, but chief among them is the fact that, after much turmoil and many false starts concerning the stability of international financial flows, overall reduction in exchange-rate volatility was finally consolidated.[4]

Emerging market currencies had already experienced a marked decrease in volatility much earlier, in the years that followed the East Asian financial crisis of 1997-98 and its ramifications elsewhere, particularly in Russia and Brazil. In an ever-widening movement of rejection of "Washington Consensus" non intervention rules, emerging market countries gradually opted for managed (or "dirty") float exchange rate regimes, usually with soft pegs to the US dollar.

Intentional accumulation of international reserves – greatly facilitated by rising levels of commodity prices in the 2000s – also contributed decisively to reduce the volatility of emerging market currencies.

The convertible currencies of advanced economies, however, have seen exchange-rate movements become stabilised only more recently, particularly in the wake of US quantitative easing (2008 through to 2012), subsequently taken up by the UK and the Eurozone countries (from 2009), and Japan (2010 through to 2014).[5]

Abundant liquidity and lower yields also contributed to stimulate the increase of currency carry trade, in search of higher returns in overseas markets, accounting in good part for the higher turnover in FX swaps, which are used precisely to manage currency risk.

4 Trading volume of FX options declined to $254 billion in 2016, 24% lower than in 2013.

5 Sweden launched its QE measures as recently as January 2015. Tighter trading supervision in the aftermath of the 2012 Libor fixing scandal and the imposition of tough monetary and regulatory sanctions by financial authorities on both sides of the Atlantic also contributed to curb speculative movements in the FX markets.

Finally, it must be noted that although much has been made in recent years concerning the growth of the non-bank financial sector, with 64% of daily trading banks still hold clear and decisive dominance in FX, the largest market of all.

Large FX-dealing banks accounted for 42% of market turnover in April 2016, while smaller and regional banks, that serve as clients of their larger counterparts but do not engage in market-making, accounted for 22%.

Institutional investors (insurance companies, pension funds and SWFs), further increased their share of foreign exchange trading relative to hedge funds and proprietary trading firms. Institutional investors were on one side of 16% of daily turnover in April 2016, up from 11% in 2013, while the corresponding share of FX trading by hedge funds and proprietary trading firms decreased from 11% to 8%.

Thus, apart from the indisputable preponderance of large banks and security houses, the new BIS survey also offers the reduced market share of speculative funds and high-frequency traders (HFTs) as further evidence of decreased volatility in FX markets.[6]

6 For now HFTs are present only in spot trading, but their target of expanding into foreign exchange derivatives is by now quite clear.