

ADVISORY ROLE OF THE FOREIGN EXCHANGE COMMITTEE

A principal purpose of the Foreign Exchange Committee is to advise the Federal Reserve Bank of New York on issues related to the foreign exchange market. At the Committee's monthly meetings at the Federal Reserve Bank of New York, members from dealing institutions provide their assessment of recent exchange rate trends and trading conditions. Members from foreign exchange brokerage firms comment on recent trends in the volume of transactions and on issues pertaining to the bank-broker relationship. Such discussions are particularly useful during periods of increased market stress or heightened volatility.

Perhaps the most obvious example of the Committee's advisory role is its member discussions on the changing nature of the foreign exchange business; specifically, how technology is changing institutional approaches to business. In 1996, several events led to related discussions; for example, market developments spurred the Committee's discussion on: electronic brokering study, and the trend toward consolidation of trading operations.

In September, the Committee reviewed the members' responses to its electronic brokering survey. The survey presentation sparked much Committee discussion, including the following observations:

- As a result of increased market transparency in the electronic brokering medium and the concomitantly more efficient price discovery mechanism, members noted that the volume of foreign exchange dealing had decreased by roughly one-third with the advent of electronic brokering.
- There has been a reduction in the intraday volatility of electronically brokered currencies which has increased market transparency and deterred market participants from trying to exploit intraday volatility.
- Electronic brokering has improved the price-discovery process, provided a disincentive to quote two-way prices, improved down-stream banks' access to foreign exchange markets, and improved trading efficiency.

Perhaps the most significant impact on the business has been the permanent, radical alteration of dealing-room economics.

Several Committee members identified the similarities between electronic brokering and the deregulation of an industry. Going forward, financial firms will likely find that consolidations continue in the FX business. The businesses that remain active after the consolidation period, however, will be more profitable.

In the context of technological improvements, in 1996 the Committee discussed further moves by some firms to consolidate foreign exchange operations into a single twenty-four-hour trading room. Modern telecommunications and computer technology have enabled firms to participate in local foreign exchange markets from remote locations globally. In recent years market participants began realizing efficiency improvements to foreign exchange confirmation, clearing, and settling operations by locating those businesses in the most cost-effective locations. In some cases, firms consolidated those operations into one physical operating center.

More recently, firms have been trying to realize similar economies in their front-office operations. While front-office consolidation is a much slower process, some firms have shifted toward a model-based structure, maintaining local sales staff, supported by a regional or twenty-four-hour trading center. The Committee intends to continue monitoring these ongoing pressures for consolidation within the industry.