

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. Committee discussions provide an opportunity for members representing various types of institutions to offer their assessments of recent market developments and trading conditions. Such discussions are particularly useful during periods of increased market stress or heightened volatility, as witnessed this year during the Asian currency crisis. In addition to a review of exchange rate trends, Committee meetings also provide a forum for members to highlight industry developments that warrant Committee attention. Such discussions typically cover a broad range of topics, including trading practices, market structure, operations, and risk management.

One recurrent theme at Committee meetings in 1997 related to potential structural changes in the marketplace. This concern reflected a variety of recent developments:

- *Greater price transparency caused by electronic broking.* In a follow-up to the electronic broking discussions and survey initiated in 1996, members noted that the efficiency of the price discovery mechanism continues to erode spreads available for market-making activities. This ongoing process has broad ramifications for traditional providers of liquidity, prompting firms to place less emphasis on market-making activities and more on value-added services, and encouraging additional consolidation in the industry.
- *Potential innovations in reducing foreign exchange settlement risk.* Committee members considered the potential impact of new settlement risk reduction tools on future trading. The ramifications of contracts for differences (CFDs) for front-office trading conventions received considerable attention given the possible bifurcation of the market into CFD and cash components.¹

¹See related discussion on CFDs in the Chairman's Report, p.1.

- *European Economic and Monetary Union (EMU)*. In addition to considering the technical and legal challenges EMU poses to U.S. market participants, members also initiated a discussion on how monetary union might affect front-office trading conventions such as the quoting of prices to customers. The Committee intends to pursue this subject in more depth in 1998.

In addition to these potential market structure issues, the Committee also provided advice on the effort to standardize foreign exchange trading documentation related to nondeliverable forwards, the upcoming BIS settlement risk survey by the Group of Ten central banks, and next year's triennial "Foreign Exchange Turnover Survey."