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III. A look at trading volumes in the euro

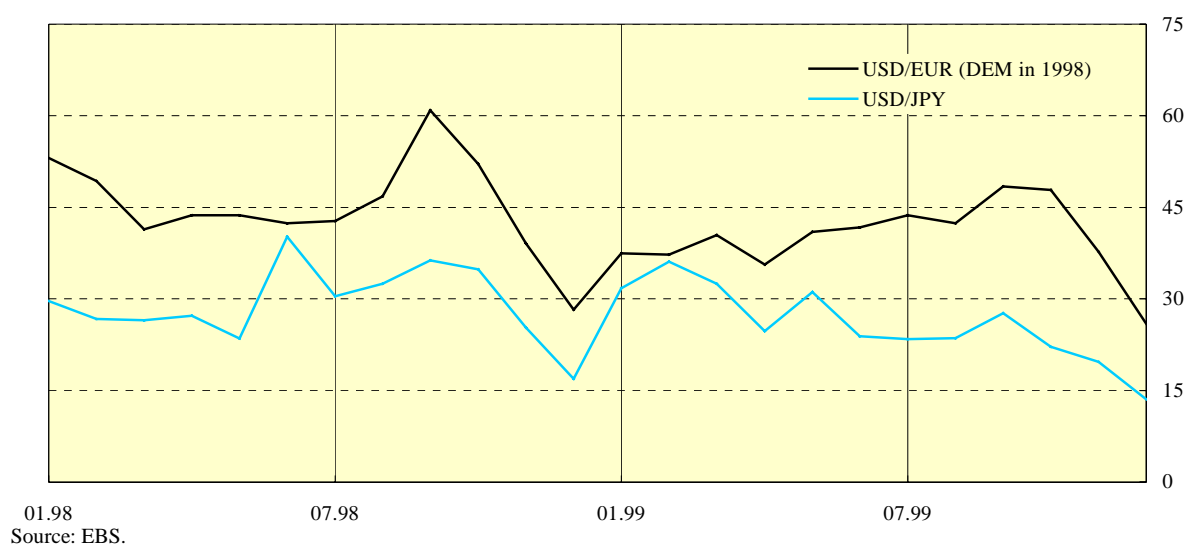
One year after the launch of the euro, it is interesting to gauge its importance as a transactions medium in the foreign exchange market. This role is important because of its implication for the euro's attractiveness to international investors. To that end, this note analyses information on trading volumes in different foreign exchange market segments.

The euro was introduced during a period of subdued FX market activity. Traders' responses to an informal survey indicate that the overall level of activity in 1999 was lower than in 1998. The fall in FX turnover accompanied a general reduction in financial market liquidity. In addition, it appears that the market share of the euro did not change substantially from that held by the mark in 1998. More specifically, the share of trading in euros against dollars in October 1999 was reported to have roughly matched that of dollar/mark trading in April 1998. Furthermore, the share of euro/yen trading accounts for only a small part of the total market. In the view of many market participants, the low liquidity of the euro/yen market has been a major disappointment. There is also some evidence of a slightly lower share of trading of dollars against yen. One conjecture is that the reduced importance of dollar/yen trading might be a symptom of the diminishing role of yen carry trades after the dramatic exchange rate movements in autumn 1998. Finally, it appears that the trading shares of sterling/dollar and sterling/euro have not changed significantly with respect to 1998.

Similar conclusions are suggested by electronically brokered spot trading volumes (see the graph below). Electronically brokered trading started to grow in 1995 (BIS (1997)). In April 1998, about 40% of spot market transactions in London were dealt through electronic brokers (BIS (1999)).

EBS spot foreign exchange turnover

Monthly averages of daily spot transactions, in billions of US dollars



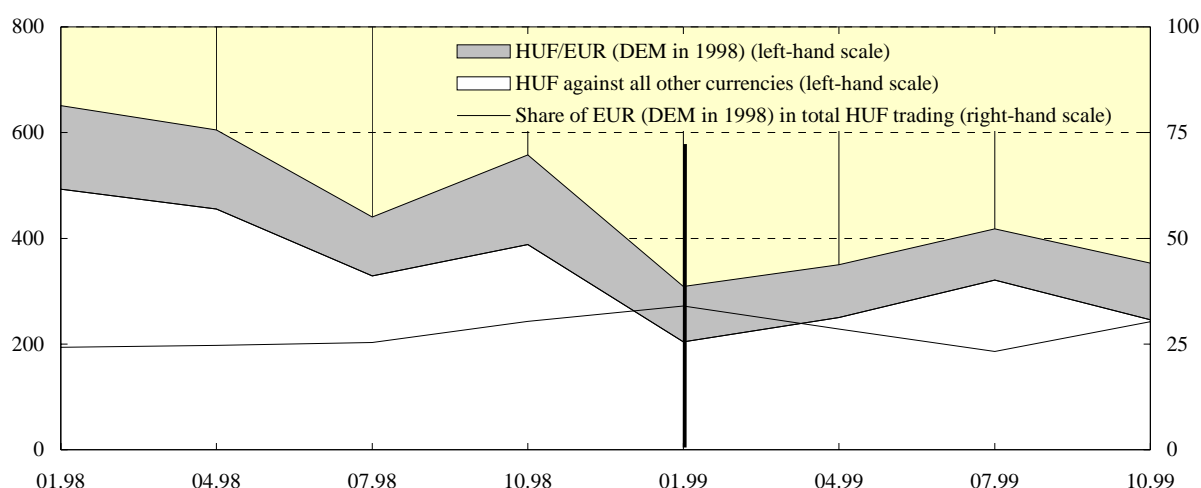
According to market sources this share increased substantially in 1999. Globally, about one third of all transactions involving the dollar, the yen and the euro are said to be currently effected through electronic brokers. Given that electronically brokered transactions cover only a part of FX markets, it would be misleading to use them as a proxy for total turnover.¹³ Subject to this important caveat, however, they support the conclusion reached by looking at traders' informal estimates.

Another source of information on the role of the euro in FX markets is estimates of trading in emerging market countries. An important issue is whether traders in these countries will transact their home currency against the euro much more than they did against its predecessor currencies and whether the euro might threaten the dollar's dominant role. While FX markets in emerging market countries are still very small, data on these markets are interesting as qualitative information.

In those FX markets, the role of the euro so far seems similar to that of the mark, being confined mainly to eastern Europe. Hungary is an interesting case because until December 1998 it managed its exchange rate by reference to a currency basket heavily tilted towards the mark. Since January 1999, the euro has taken over this role. The graph below shows that, with a share of total trading involving the forint of about 25%, trading against the euro in 1999 was no higher than trading against the mark before January 1999.¹⁴

Foreign exchange market: Hungary

Left-hand scale: millions of US dollars per working day; right-hand scale: percentage shares



Source: National Bank of Hungary.

In emerging markets outside eastern Europe, the euro's role remains limited, as was that of the mark previously (Galati (1998)). In Thailand and Korea, for example, less than 1% of all transactions involving the domestic currency are conducted against the euro. In South Africa this fraction is only slightly higher than 1%. In Brazil, 85–90% of all trading of reals against foreign currencies is against the dollar.

¹³ It may be misleading to gauge developments in total FX volumes from electronically brokered volumes alone for two reasons. First, part of the changes in volumes may be the result of the substantial increase in their market share over the last 18 months. Moreover, because of the fundamentally different price discovery processes of electronic brokering and other means of FX trading, a decrease in electronically brokered volumes may not reflect a reduction in liquidity.

¹⁴ Moreover, when we consider transactions taking place in Hungary that do not involve the local currency, trading volumes for dollar/euro are not much larger than trading volumes for mark/dollar before 1999. It is interesting to note that local FX trading is still dominated by the dollar, which captures about 75% of total activity.

Our analysis suggests that the introduction of the euro has not to date caused major changes in FX market activity. The euro made its appearance at a time of reduced overall FX market volumes. In terms of its importance in FX trading, the new currency roughly matches the mark. This appears plausible given that the euro did not start with a “Big Bang”. Rather, markets had been preparing for its arrival for several years, as the trends in trading of European cross rates through EBS shows (BIS (1998)). The next BIS triennial central bank survey of foreign exchange and derivatives market activity, scheduled for 2001, may be useful to test whether FX markets will by then have found a new norm.

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