

A large black silhouette of a hand holding a rope, which is tied to a valve handle. The background is a solid teal color.

Boosting liquidity and best execution for emerging market currencies

One main stumbling block to growth in electronic FX execution of EM currencies is liquidity especially since the majority of the market is usually for local currencies that are not only illiquid but are also often under some form of capital control. Joe Morgan explores some of the issues involved.



“EM FX is all about politics,” says Jon Vollemaere, the London-based chief executive officer at R5FX, an electronic marketplace for EM FX and electronic non-deliverable forwards. “The potential of a trade war brings more attention to the whole area which is actually a good thing. More attention typically creates more liquidity and more participants at the same time.”

A looming trade war between the US and China has heightened levels of political risk across EM. President Donald Trump has decided to impose tariffs on about \$50 billion in Chinese imports, according to a Bloomberg News report.

Trump has claimed that “trade wars are good, and easy to win”. His rhetoric has fuelled the escalating trade dispute between the world’s two biggest economies with China unveiling plans to impose tit-for-tat tariffs of up to \$3 billion on US imports.

Adding to the negative sentiment on EM, Harvard economist Carmen Reinhart recently proclaimed that the plight of EM is now worse than during the 2008 financial crisis. Reinhart highlighted the increasing strength of the US dollar, along with growing debt problems in Brazil, Chile, Argentina, Turkey, sub-Saharan Africa and the Middle East.



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Joe Conlan, global head of FX sales at INTL FCStone, a Fortune 500 financial services and brokerage firm based in New York, says international trade wars are likely to be conducted on a bilateral basis between China, Mexico and the European Union and therefore not likely to have a direct impact on EM FX. "However, in general anything bad for the global economy will trickle down in a negative way to EM," he adds.

SOURCING EM FX LIQUIDITY

Vollemaere contrasts the "normalised" landscape of the G10 with the vast divergences in the market microstructure underlying different EM currencies. He describes trading in EM currencies as being done on a "case-by-case" or "currency-by-currency" basis. "The drivers behind INR for example are not the same as CNH or RUB. INR can be driven by six Indian guys in a room with an algo operating out of Singapore or Dubai. Half the INR market is outside of India. EM is very different to the G10 in every way," he says.

Meanwhile Stamos Fokianos, global head eBusiness at Crédit Agricole CIB in London, says that "the different liquidity profiles that exist across the EM landscape make it difficult to define any rules that can be applied to every currency in these regions." He also points out that the continual provision of liquidity – regardless of market conditions – requires spreads to also be widened appropriately. "You can't create liquidity if it doesn't exist," he says, adding that another key differentiator of EM trading is that unlike

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Stamos Fokianos

the G10, it generally does not operate 24 hours a day.

Inherent geopolitical risks in countries such as Turkey and Syria have a knock on impact on the level and quality of liquidity. Fokianos says the correlation of currencies such as the Turkish lira with political events result in "big gaps in prices", providing trading opportunities. Meanwhile, the more stable established trading hubs such as Hong Kong, Singapore and those in mainland China offer investors the best sources of liquidity. "You also have to consider non-bank liquidity," he says. "For example, a lot of hedge funds that do not want to pay the spread will go on secondary markets and make the prices themselves. This is not liquidity that you will find from banks. This is liquidity that you will find coming back into the market."

Liquidity varies significantly according to the timezone and currency pair, but commitment to supplying liquidity means understanding how to

warehouse and manage risk, outside of the normal liquidity window, without creating a significant footprint and without increasing significantly the cost of execution, says Fokianos.

Joe Nash, global head of e-FX Sales at BNP Paribas in London, says the distinct characteristics of the EM landscape makes it imperative for electronic FX platforms to deploy trading technology that is specifically designed for this space. "People assume that you can just take an architecture that works for G10 e-FX and transfer it to a local market FX and that's not really how it works," he says. "We at BNP Paribas are facilitating an improvement in liquidity in local markets by investing in bespoke IT architecture to allow us to stream local market prices at tighter spreads and greater size."

For example, BNP Paribas has invested in its Asian non-deliverable forwards (NDFs) offering by making tailor-made improvements in its trading architecture, according to Nash. He highlights recent success that BNP Paribas has seen in the onshore India market, which has this year become the bank's eight biggest market in terms of volume traded. "In India we've invested in making sure that we have access to the local onshore market to be able to hedge when we put that price out," says Nash.

Nash points to the great latent potential within EM FX for the increasing deployment of



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electronic trading. “Right now 85 percent of the volume in G10 FX is traded electronically,” he says. “It is a highly commoditized space. Whereas if you look at local markets, we’ve got a strong local markets offering and are at around 45 percent in terms of the volume traded electronically. From that viewpoint it is fairly clear where we are seeking to expand our as a e-FX business.”

Fokianos says access to EM liquidity is also being boosted further as global exchanges develop their on-exchange FX offerings in response to legislation such as the EU’s European Market Infrastructure Regulation (Emir), which provides a framework for OTC derivatives not cleared by a central counterparty. In January 2018, for example, The Moscow Exchange expanded its FX product offering to include the Turkish lira, providing clients

with access to TRY/RUB currency pairs. Meanwhile, the Singapore Exchange (SGX), Asia’s biggest listed FX venue, has unveiled plans to launch customised FX futures products.

MANAGING EM EXPOSURE

Buy-side firms seeking to manage their EM FX exposure continue to face challenges, according to Vollemaere. “It is an area where the market has been quite opaque in the past, meaning some banks have been able to benefit at the expense of clients,” he says. “Getting good pricing in EM currencies is very hard and so those who have traditionally managed access have been able to charge accordingly,” he says.

While the EM terrain was largely the exclusive preserve of big sell side firms servicing corporate clients the terrain is also becoming the focus of hedge funds and Commodity Trading Advisors (CTAs). These funds are adding additional sources of liquidity to the benefit of buy side traders, according to Vollemaere.

He says non-bank market makers have an increasing presence, along with electronic FX markets such as R5FX, resulting in liquidity being opened up to a wider audience and enhancing levels of price discovery. “I don’t see banks helping non banks to access EM – quite the opposite. But they are now helping their traditional clients with better EM hedging and more automated pricing,” Vollemaere adds.

BNP Paribas deploys FX algorithms that are specifically designed for the EM terrain and take into account thinner levels of liquidity than those for major G10 currency pairs such as euro



Joe Nash

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Electronic FX platforms need to deploy technology that is specifically designed for this space

dollar. “We’ve written a whole lot of logic around better execution specifically in local markets,” explains Nash. “For example, we’ve got a lot more randomization about our order placement, governing where and when orders are placed. We encourage our clients to use our algo for big orders in local markets because we are confident that it will likely have a minimal local impact.”

Credit Agricole CIB also deploys a suite of sophisticated algorithms that have the capacity to execute large orders effectively even when levels of liquidity are thin. “The worst thing you can do is just go to the market and throw the whole order in,” says Fokianos. “One potential strategy is to use algorithms whereby you put in an amount and then you stipulate where and in what quantities you want that amount to be executed via a number of smaller channels at the best price possible.”

Vollemaere of R5FX says the

electronic marketplace obtains requests for access to EM liquidity from a wide range of institutional investors, including those hedging equity or bond exposure or exchange-based futures. “It creates a deeper pool of liquidity and that’s good for everyone,” he says. Vollemaere highlights how FX EM participants are adopting the more advanced technological tools already commonplace among those trading G10 markets. “Our job for the last two years has been getting users off the phone and on to the screen,” he says.

KNOW YOUR EM FX RISK

Nash of BNP Paribas points out that there are great divergences within the EM landscape that need to be accounted for in FX risk management strategies. For example, while the Chinese Yuan has characteristics very similar to a G10 currency, with the CNH/USD being the bank’s seventh most heavily traded currency pair whereas the Thai Baht requires tailor-made risk management

strategies. “With CNH you can use the G10 architecture we’ve built for hedging and risk management,” he says.

Conlan of INTL FCStone also highlights the importance of understanding the different characteristics of each EM currency. Conlan points out that high interest rate differentials and less liquidity create challenges for hedgers with longer time horizons. “NDFs carry fixing risk, while pegged currencies are exposed to massive revaluations. The Swiss National Bank’s removal of the Euro peg should provide as an ample cautionary tale for anyone with risk to a pegged currency,” he says. “These pegs eliminate volatility in the short-term, but create risk over the long term.”

Conlan says the level of confidence that the market has in a country’s government is also an important factor. For example, the Turkish lira has fallen sharply this year amid double-digit inflation and a widening current-account deficit. The Argentine Peso has also been battered as President Mauricio Macri turns to the International Monetary Fund for support. “Since 2014, Russia has been hit by one crisis after another with ever increasing sanctions, a volatile oil market and local bank challenges yet liquidity has remained pretty constant,” says Conlan. “In contrast, you have situations such as Turkey and Argentina where there have been great strains in those currencies.”

Vollemaere says that institutional investors with exposure to EM corporates are becoming increasingly aware of the

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Jon Vollemaere

importance of hedging their FX risk, rather than just focusing upon the microeconomics of the company. MSCI's addition of 234 domestically listed Chinese companies – including ICBC A and China Construction Bank – to its benchmark indexes in June will create an additional FX risk for institutional investors adding the stocks to their holdings, according to Vollemaere. “Some index funds will be forced to buy the underlying stock as well,” he says. “This creates an interesting question for their FX risk. Even though the renminbi has a cap on it and can't move outside its band, when it does start to open up a bit further there will be a big shift in the price.”

LOCAL CONTACTS

Given that EM liquidity can be much thinner than for G10 currencies, Fokianos highlights the importance of bilateral relationships with banks in the region as a means of sourcing liquidity. A European bank lacking sufficient liquidity in a local currency – Singapore dollars for example – can set up a bilateral arrangement with a local bank, whereby the local currency is

exchanged for euros. “That can be done over the phone or on a platform. There are many ways of doing that. But it is a bit of a special relationship. You can source liquidity in a more trusted way and in a more exclusive way,” says Fokianos.

Meanwhile Nash of BNP Paribas also highlights the importance of banking relationships on the ground as a means of bolstering liquidity in EM FX trading, describing access to data in EM markets and liquidity analysis as being “incredibly useful”. “That flow of information is a lot easier when you are on the ground and have an onshore presence,” he says. “As opposed to if you are an offshore bank and offering liquidity in Turkey but don't really have a large presence there and are not really connected to the Istanbul finance industry in a face-to-face way.”

A 'FREEMIUM' RESEARCH MODEL

Aimed at boosting transparency, the Markets in Financial Instruments Directive (MiFID) II rules on unbundling – which require banks to charge for research separately rather than lumping it in with trading commissions – has left EM participants taking steps to avoid being left in the dark, according to Vollemaere. “New models are surfacing with a Spotify approach to offering FX research via a freemium model, or very low

monthly costs for subscription,” he says. “The user pays for access to the economist who wrote it for the deeper view or can field questions instead. For the big audiences in EM markets, this could work out very well indeed.”

EM TURMOIL UNLIKELY TO DAMPEN FX LIQUIDITY

While some economists have raised the specter of the late 1990s-era Asian economic crisis, EM FX demonstrates robust levels of liquidity. The increasing deployment of sophisticated algorithms, deepening relationships on the ground and the migration of FX products on to an exchange-based trading model all appear set to bolster still further levels of EM liquidity. Vollemaere of R5FX argues that increasing levels of political risk – and the subsequent spike in volatility levels – may even benefit EM liquidity. “From a speculation point of view things are more exciting and more active than euro dollar,” he says. “Spreads are wider, markets are more fragmented so there are more trading opportunities.”



Joe Conlan

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