

Chapter 2 Summary

Risk and Resilience in the Global Foreign Exchange Market

The foreign exchange (FX) market has become the world's largest and most liquid financial market, driven largely by rising participation of nonbank financial institutions and increased use of derivatives for hedging currency risks and funding. While this growth may have enhanced market liquidity and diversified risk, it has also introduced greater complexity and tighter interconnections, making the market more vulnerable to stress episodes.

Using a unique cross-country dataset on FX spot and swap trades in major currencies, this chapter analyzes how heightened macro-financial uncertainty affects FX market functioning and its implications for financial stability. Periods of uncertainty tend to trigger flight-to-quality flows and stronger hedging demand, driving up foreign-currency funding costs, widening of bid-ask spreads, and increased excess exchange rate return volatility, particularly for emerging market currencies. These pressures are amplified by structural vulnerabilities including larger currency mismatches on the balance sheets of financial institutions, reliance on a few dealers, and high participation of nonbank financial institutions in trading activity.

Stress in the FX market can transmit rapidly to other financial markets, posing broader macrofinancial stability risks. Rising funding and hedging costs can affect risk premiums of stocks and bonds. They may also limit the ability of financial institutions to intermediate, tightening financial conditions and posing broader macro-financial stability risks. These impacts are magnified in countries with elevated macro-financial vulnerabilities, such as significant currency mismatches or high fiscal risk.

The chapter also shows that, beyond sensitivity to adverse macroeconomic shocks, FX markets are highly exposed to operational disruptions such as cyber incidents, and settlement risk: the possibility that one party will deliver its currency without receiving what the counterparty owes. The chapter's analysis shows that settlement risk is particularly relevant for emerging market and developing economies, many of which are outside risk mitigation arrangements, such as payment-versus-payment (PvP) mechanism that settles both sides of an FX transaction simultaneously.

To bolster resilience, policymakers should strengthen surveillance to monitor systemic risks arising from FX market stress. Enhanced liquidity stress tests and scenario analysis are useful tools to assess how FX market disruptions could transmit across the financial system. To support effective monitoring, closing critical data gaps, such as on the positions of nonbank financial institutions and settlement exposures, should be a priority. Institutions should maintain adequate capital and liquidity buffers, supported by a robust crisis management framework. Operational resilience must be strengthened by improving cyber security and contingency planning to ensure that key FX market participants and infrastructures can recover quickly from disruptions. Reducing settlement risk is another critical step, with broader adoption of PvP arrangements offering an important safeguard. Moreover, strengthening the design and resilience of trading and post-trade platforms can lower transaction costs, dampen volatility, and limit both counterparty and settlement risks.

To see the full report, please refer to the English version here: <https://www.imf.org/gfsr-october2025>