



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Foreign Exchange Contact Group

Frankfurt am Main, Wednesday, 7 December 2022, 12:30-16:30

SUMMARY OF THE DISCUSSION

1. Review of recent markets developments and market conditions

Alan Stewart (Goldman Sachs) reviewed recent developments in the global foreign exchange (FX) market. His comprehensive presentation highlighted reasons for the recent reversal of the US dollar strength and that emerging market currencies have overall remained resilient, supported by an early monetary policy tightening, and friend-shoring, with some regional differentiation.

The discussion centred around Europe, which faces multiple challenges, including fiscal risks. The risk around the euro area economic outlook was seen as under-priced amid the long-term negative impact of energy supply. Some members expected higher energy prices in the second quarter of 2023 as China's economy reopens and Europe's LNG inventory stock runs down. The EURUSD fair value, going forward, was seen at levels well-below those prevailing before the energy shock. One member stressed that the main reason for higher energy prices is a result of lack of investments in traditional sources of energy in recent years and expects investments for both fossil fuels and renewable energy sources to increase given high demand.

FX implied volatility is expected to remain elevated amid the uncertainty around the evolution of global inflation and the growth outlook. The pace, duration and level of the monetary policy tightening cycle between regions will matter for the FX outlook. The ECB was seen as more constrained than the Fed implying the ECB's hiking path may be shallower and longer. The big question mark was mentioned to be China, but even if its pandemic restrictions were eased and its growth to pick up, the main beneficiaries were seen to be Asian countries and Emerging Market exporters into China rather than the UK or the euro area.

2. The impact of digital assets on the FX market landscape and product suite

Joshua Mathew (Flow Traders) and Stéphane Malrait (ING) introduced a group discussion on the impact of crypto or digital assets on the FX market. Digital asset

solutions were seen as having the potential to improve financial inclusion and cross-border payments, with some solutions sharing similarities with the existing FX product suite. A broad discussion took place about the real economic value of different types of digital assets and technologies, which were regarded as two separate issues. Members highlighted potential benefits in terms of useful new technology solutions (e.g. distributed ledgers) for settlement and netting purposes or broader tokenization helping e.g. SME focussed solutions. Increasing number of ideas are being tested in various piloting projects by private and public sector.

Various challenges were also recognized, in particular the lack of clarity around regulatory oversight, the lack of transparency on some crypto exchanges, high energy consumption of many products, punitive capital requirements for banks, and examples of assets being used for illicit purposes. Despite them, members reported continued strong client interest from retail and institutional clients.

3. Exploring the effects of the Standardized Approach to Counterparty Credit Risk (SA-CCR) and Uncovered Margin Rule (UMR) on FX market trading and liquidity conditions

Chris Callander (Société Générale), Alexandre Dewhurst (guest speakers from Société Générale) and Elke Wenzler (MEAG Munich Ergo) kicked off a discussion on the first effects of SA-CCR and UMR in the FX market.

Both regulations are seen to prompt more interest towards using cleared FX products and requiring swap dealers and their counterparties to post initial margin for OTC derivatives, but the impact differs across FX instruments and regions (i.e. Europe vs US). SA-CCR was told to influence in particular short, dated FX swaps and forwards, providing better recognition for risk offsets for CCP cleared derivatives. This however makes some transactions more expensive and requires increased focus from buy-side institutions to manage their counterparty concentration risk. It also makes it more difficult for banks to forecast their leverage positions on OTC derivative exposures. As this is still an early phase of those regulations in place, members asked to rediscuss the effects once more experience is gained.

4. BIS Triennial Central Bank Survey

Mathias Drehmann and Vladyslav Sushko (guest speakers from BIS) presented key takeaways from the 2022 BIS Triennial Central Bank Survey and invited FXCG members to discuss the findings.

The BIS FX Triennial Survey, which covers 1,300 reporting institutions in more than 50 countries showed that global FX trading turnover increased amid higher volatility to a record

high of USD 7.5 trillion per day; a 14% rise from the 2019 survey. FX swaps led the broad-based growth with a 19% increase from 2019 and raised their share to 51% of all FX transactions (spot, forward, FX and currency swaps and options). The greater use of short maturity FX swaps may reflect market participants' aversion to taking on term risk in a more volatile environment. Inter-dealer trading volumes increased relative to customer-dealer trading and dealers' trading with customers declined on anonymous venues across instruments.

Members generally agreed with the results of BIS survey but discussed whether the rise in outright forward trading reported by banks might be attributed to hedges or erroneous reporting. Members attributed the rise in banks' single dealer platforms to higher use of execution algorithms and offers for preferential pricing which allows higher use of internalisation, and highlighted that internalization increased among regional players especially in Asia. One member noted that the strong rise in Chinese Renminbi trading may partly explain the increase in aggregate non PvP settlement share, since the currency is not in the CLS system. Members also mentioned that more granular data classification would be valuable.

5. Global FX Committee and FX Global Code and other items

Chair Toto Silvonen debriefed members on the Global FX Committee's Meeting on 5-6 December and invited members to provide input for next year's FXCG work programme.