EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Wednesday, 26 May 2021, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of recent market developments and outlook

The Group discussed the foreign exchange (FX) market review and outlook, focusing on major currency pairs. In terms of FX market functioning, the bid-offer spreads for EUR/USD and other major currencies had been declining but were not yet fully back to pre-pandemic levels. According to some members, this indicated persistent uncertainty in FX markets, mainly related to the rising inflation expectations in the United States and, to a lesser extent, pandemic risks. However, other members questioned whether bid-offer spreads were a reliable indicator of market uncertainty as, on the contrary, volatility indicators on EUR/USD and other major currencies painted a calmer picture, with low volatility when compared with the recent decade.

Regarding the outlook for the EUR/USD exchange rate, most members did not expect it to rise meaningfully above 1.24-1.25 and expected the US dollar depreciation to reverse towards the year-end when the Federal Open Market Committee (FOMC) officials would begin discussing their plans to adjust the pace of asset purchases. Asset managers, hedge funds and real money investors had reportedly been positioning for a weaker dollar amid lower real yields, particularly against the euro and the Chinese renminbi. Euro-negative risk events on the horizon would be the German and then French general elections, taking place later this year and next year.

As regards central bank communication, members of the Group emphasised that consistency among ECB Governing Council members was important and that recent statements by several members had been helpful in preventing a sharp increase of the euro. Some FXCG members expected that the exchange rate would be explicitly mentioned at the upcoming press conference.

The Group acknowledged generally subdued trading activity in major FX currency pairs, mainly owing to low volatility. Market participants' interest had shifted more generally to riskier and more volatile asset classes such as crypto assets, offering more trading opportunities and larger expected returns for the time being. Some of the decline in FX volumes was attributed to a seasonal decline that is typical in April following the end of the fiscal year in many countries.

Some members had increased their own activities in crypto assets and mentioned increased investment interest via retail funds. Members also cautioned that the crypto-asset market was still largely unregulated, making it more prone to misconduct-related risks and more vulnerable to manipulation. Regarding central bank digital currencies, several representatives advocated that Europe should catch up with the ongoing initiatives in other countries (particularly in Asia) by speeding up its efforts on the digital euro.

2. FX futures and exchange-traded derivatives

A presentation was made to the Group on the FX futures market, including an overview of the FX futures exchange landscape and the longer-term outlook for this market segment.

The leading global exchange for listed FX derivatives in terms of volume is in the United States. It is de facto the only global exchange offering a broad range of currency pairs, whereas other exchanges in a few emerging markets (Brazil, India, Russia) focus solely on their domestic currency against the US dollar. In this context, according to some members, there was a case for promoting a European FX futures market, also from a competition perspective.

Recent regulatory initiatives (MiFID II, Basel III and especially uncleared margin rules) were viewed as the most likely driver of growth in the FX futures market segment going forward. The presenters forecast that FX futures could potentially account for 20-25% of spot volumes in five years from currently 4-6%. Some asset managers within the Group agreed that FX futures have advantages in terms of efficiency for hedging and investing, also because they are structurally asset-rich (allowing them to comply with the collateral requirements more easily) and could benefit from cross-margining. Some other members were more cautious as the collateral requirements for trading FX futures would be prohibitively high for most corporates with large one-way hedging needs. Several members were sceptical whether banks would start market-making in FX futures more widely alongside high-frequency trading firms, because the costs of investing in the required high-frequency technology were viewed as too high for banks relative to the expected trading volumes and revenues.

Part of the discussion focused on the functioning of the FX futures market in episodes of high volatility, and members confirmed that no significant disruptions were experienced during the COVID-19 crisis. Certain rules in place at the futures exchange, such as the “circuit breaker” which pauses trading in episodes of extreme market volatility, were considered beneficial for market functioning.

3. FX Global Code and Global Foreign Exchange Committee (GFXC)

The Group received an update on the remaining steps in the three-year review of the FX Global Code and were informed about new documents which had been posted to the GFXC webpage.