

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 21 September 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. In the third quarter of 2021, volatility and trading volumes were low in the FX market, as had been the case in previous quarters. Seasonal patterns of trading activity were even more muted than they usually are at this time of year. The remote working environment and a lack of monetary policy divergence across countries, in addition to the summer lull, may have contributed to the low level of activity. With regard to structural market shifts, FX futures trading on some exchanges grew at the expense of traditional over-the-counter FX spot trading. Nowadays, FX futures often lead spot FX in terms of price discovery. The low market volatility reportedly caused some market participants to shift to trading more volatile crypto-assets. Moreover, a number of new entrants had recently appeared in the FX options market, which they had started using as a proxy to hedge against risks in their equity holdings.

With regard to the currency outlook, some members expected the euro to remain range-bound versus the US dollar until the end of the year. The euro area economy may outperform the US economy in the coming quarters, largely thanks to the more positive fiscal impulse in the euro area compared to the United States, where fiscal spending discussions are stalling. If the upcoming German federal elections result in a centre-left coalition, fiscal spending in the euro area could increase, which would be a net positive outcome for the euro. However, the market is not prepared for a coalition involving the far left and there is a point at which additional fiscal spending could be perceived as unhealthy.

Some members expressed the opinion that the market could be under-pricing inflation risk and therefore developments in the United States and Europe could be similar to those already seen in Asia. Rising natural gas prices in Europe are contributing to the risk of more enduring inflation. Among other key market risks, members mentioned the economic slowdown in China, although they seemed less concerned about the systemic importance of the looming default of the Chinese property developer Evergrande, describing the problem as “worrisome but manageable”. Members commonly shared the view that spillovers to other credit market segments had so far been limited and in the past the Chinese authorities had found ways to contain such crises while upholding market discipline.

Overall, expectations regarding FX market developments were fairly muted although a few members expected volatility to rise.

2. Digital currencies

One ECB staff member delivered a presentation on the digital euro, outlining plans for the central bank digital currency (CBDC) project investigation phase and its complexities, including numerous still-pending design choices. Several members of the FX Contact Group cautioned that if the implementation of a digital euro is postponed for too long other public and private-sector digital money initiatives may benefit, including unregulated crypto-assets. Members argued that more efforts should be made to establish a digital euro, which would also be a way to promote the euro as an international

reserve currency. Some members questioned whether the retail nature of a digital euro would make it sufficiently attractive to compete with other CBDCs, given that its cross-border benefits would be limited.

The Group received a presentation on recent global developments in CBDCs. Crypto-assets had either become legal tender or been legalised in El Salvador, Panama and Ukraine, serving as examples of the rapid penetration of digital means of payment and arguing in favour of the prompt development of CBDCs. In terms of adoption in larger economies, members noted the largely opposing stances of China and the United States on CBDCs. More widespread use of CBDCs and crypto-assets could challenge the US dollar's dominance in the longer term and undermine its exchange rate valuation.

There was a lively discussion about crypto-assets and, more broadly, the disruptive effects of distributed ledger technology on the FX market. Many members observed that the younger generation had a high level of interest, openness and readiness regarding the use of mobile payment services and crypto-assets. While members were aware of the potential of distributed ledger technologies to reduce the settlement cycle for FX and securities to real-time "T+0" settlement, with benefits for settlement efficiency and a reduced settlement risk, one member argued that the role of the traditional sell-side market-maker would have to be redefined for trading any currency. This is because real-time settlement would require market-makers to support larger and less efficient inventories of all the relevant (digital) currencies, whereas bank treasuries currently have two days to source them before spot settlement.

3. FX Global Code

The Chair reminded all participants that the updated FX Global Code was published in July and that adherence to the Code is a condition for membership of the FX Contact Group. He conveyed the ECB's expectation that members should ensure that their organisations' practices are aligned with the Code's updated principles within a period of twelve months from July 2021. He also informed members of the efforts of the European System of Central Banks to adhere to the Code well within the timeline and invited all participants to actively use the new disclosure cover sheets. These cover sheets were designed to harmonise disclosure practices across Code-compliant FX liquidity providers and trading platforms.