

Foreign Exchange Contact Group

Frankfurt am Main, Thursday, 25 November 2021, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of recent market developments and outlook

A guest speaker FX strategist introduced the market review and outlook topic, and then members held a Q&A session. **The recent divergence in the monetary policy stance of the Fed compared with that of many other central banks had caused a widening in short-term yield differentials between US Treasuries and other global bond markets and had led to an appreciation of the US dollar against most developed and emerging market currencies.** This appreciation had occurred within orderly market conditions, as the FX market was lightly positioned and large volumes had not given rise to heightened realised volatility. The notable pressure on specific emerging market currencies (e.g. the Turkish lira and Mexican peso) seemed rather to be related to domestic idiosyncratic developments in those countries. Looking ahead, the lack of significant reaction by Fed officials to the repricing of market expectations towards a quicker tapering of quantitative easing and a more front-loaded approach to hiking interest rates suggested that the strong US dollar phase could continue over the next three to six months. In terms of valuation, the current value of the USD was not assessed to be problematic, as it was broadly in line with the levels prevailing in 2019. In such an environment, market participants would hesitate to re-enter positions in emerging market currencies as part of so-called carry trades.

Most members confirmed the view that the US dollar would strengthen against the euro, particularly based on their expectations regarding the central banks' respective outlooks for monetary policy. In their opinion, recent communications by members of the ECB's Governing Council suggested a comparatively more patient stance by the ECB, which would be conducive to an even lower EUR/USD exchange rate. The increasing scarcity of euro-denominated collateral, owing to lower expected sovereign debt issuance going forward and the expected continuation of the ECB's asset purchases, was creating pressures in the EUR/USD cross-currency basis. This, in turn, was contributing, albeit in a more limited way, to the ongoing downward trend in the spot exchange rate. Moreover, some members cited the potential of renewed lockdowns in euro area countries as an additional near-term downside risk for the euro. On the other hand, the main upside risks were associated with potential changes in the ECB's rhetoric regarding the inflation outlook or the post-PEPP calibration of monetary policy.

Several members highlighted that FX market liquidity in the major currencies was uneven across the various market segments, with ample liquidity in the spot market, but poorer conditions and wide bid-offer spreads in the forward and swap markets, particularly in tenors crossing the year-end. Some members mentioned that the EUR/USD basis swap pricing was being impacted by the scarcity of high-quality collateral in certain jurisdictions in the euro area. Liquidity in FX option markets was concentrated around a few key market events, such as the Fed, ECB and Bank of England policy meetings in December and forthcoming CPI releases, but otherwise was largely absent. The somewhat elevated option-implied volatility contrasted with still very low realised volatility in most major FX currency pairs.

2. Recent developments in energy commodity markets

A guest speaker opened the session with a presentation on global energy commodity markets, with a particular focus on oil market developments. Following the recent coordinated action by the United States and some other countries to release part of their strategic petroleum reserves to counter rising fuel prices and energy costs, the key question for the near-term oil price outlook would be whether OPEC+ member countries would respond by slowing the pace of planned output hikes. Looking ahead to 2022, the combination of the recovery in the demand for oil to pre-pandemic levels and the emerging constraints in the production capacity of some OPEC countries could keep the supply/demand balance in the market relatively tight and maintain oil prices at current or somewhat higher levels, despite oil futures curves being downward-sloping. Oil futures curves implied an eventual decline in prices towards USD 70 per barrel by the end of 2023, which is perceived by the market as the minimum level that, at the margin, would incentivise the expansion of production facilities. The speaker emphasised that a significant share of the release of strategic reserves would take the form of a loan and would thus not lead to a net increase in supply and that the growing impact of environmental, social and governance considerations had restricted capital investments in oil production.

The discussion turned to the transition from fossil fuels to renewable energy. It was recognised that recent climate change fora, such as COP26, and the global push toward sustainable finance had made access to capital markets more challenging for many oil producers. At the same time, while the long-term transition to renewable energy seems obvious, the outlook for oil demand is still positive over a five-year horizon, because the transition is expected to be very gradual, and some regions are less able or less actively tackling the challenges to develop and use renewable energy sources.

3. Cross-currency instant payments based on the TIPS platform

Staff members from the ECB and Banca d'Italia presented a concept for a future initiative of the Eurosystem and Sveriges Riksbank aimed at settling instant payments between the euro and Swedish krona on the TARGET Instant Payment Settlement (TIPS) common technical platform. The concept is based on a currency conversion mechanism that involves a competitive or market-based determination of the exchange rate. The FXCG members were invited to provide their feedback. FXCG members had several questions, mainly focusing on the Central Exchange Hub concept. Some members stated that further elaboration was required on many details in order for the idea to be successful. These included clarifications on the underlying trading model (e.g. Central-Limit Order Book or Request for Quote/Stream), the transparency of the entire mechanism and the length of the validity of the quoted rates.