

Foreign Exchange Contact Group

Frankfurt am Main, Tuesday, 8 February 2022, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of recent markets developments and outlook

The Group discussed recent developments in the FX market and possible future drivers for major currency pairs.

The functioning of the FX market has been orderly of late, with generally stable bid-offer spreads near pre-pandemic levels, despite the increase in realised and option-implied volatility since the beginning of 2022. The market is looking through the near-term impact of the Omicron variant.

New global risks have emerged, however, notably the potential further escalation of geopolitical tensions over Ukraine. Members concurred that the risk of general market disruption was currently less pronounced than in 2014 during the tensions over Crimea. A few members expressed the view that, even if sanctions were imposed, Russia would remain able to process rouble-denominated payments via its domestic alternative to the SWIFT network. The exclusion of Russian banks from SWIFT was considered unlikely. Meanwhile, Russia's reduced reliance on external financing could largely insulate it from global markets and contain wider global spillover effects. Still, some members acknowledged the risk that this crisis might trigger a broader equity market correction. Moreover, they noted that increasing volumes of international rouble trading had recently migrated from the Russian domestic exchange MOEX to the international trading platform EBS, and there was a growing divergence in pricing between rouble for physical delivery and the cash-settled/non-deliverable market segment.

Members generally felt that a military escalation could significantly disrupt the EU energy and base metals markets rather than the currency market. For example, crude oil prices could rise by 5 to 10 USD per barrel and EU gas prices might double in the event of a full-blown conflict. Most members were of the view that an energy supply shock would further skew the risks to inflation in the euro area towards more persistent above-target levels. One member mentioned that an EU energy crisis could cause the euro to depreciate which, in turn, could create second-round effects for higher inflation. Long-term market-based measures of inflation expectations, such as the five-year five-year forward, do not reflect this, arguably

because the attention of market participants was on the front end of the yield curve for the time being, although this could change going forward.

In anticipation of the Fed hiking cycle, the US dollar was viewed as having the potential to outperform owing to the growing interest rate advantage of the dollar over a basket of other major currencies. However, market participants have already largely anticipated dollar appreciation, as evidenced by positioning indicators. In addition, investor flows could become more supportive for euro area equity markets, and hence the euro, at the expense of the dollar. Looking backwards, volatility spikes in the foreign exchange market have continued to be mostly observed on central banks' monetary policy meeting days. **Looking ahead, FX option implied volatilities indicated that the March FOMC and ECB Governing Council meetings, as well as the French Presidential elections in April, would be the key events for the EUR/USD pair in 2022 and a possible source of sharp moves in the exchange rate.**

The discussion turned to cash management in euro, US dollars and pounds sterling around the 2021 year-end, with members noting the difficulties and high costs of investing euro liquidity via money market funds and FX derivatives. By contrast, funding was smooth. The cash management issue was less pronounced for US dollar liquidity. Several speakers noted that the tensions in 2021 had been more severe than at previous year-ends. The case was made that regulators should consider the perspective of the end users of liquidity when designing reforms to the EU Money Market Fund Regulation.

2. FX trading volume patterns and activity around benchmark fixings

The Group discussed recent trading volume patterns in FX, with a particular focus on the concentration of activity around the 4 p.m. UKT WM/Refinitiv benchmark fixing as well as around specific times of the day and month-ends. The presentation highlighted how FX trading volumes increase during the five-minute fixing window, across currency pairs, which has been typical behaviour in recent years. The volume spikes were more pronounced at month-ends, likely linked to hedging flows. Most of these flows are automated nowadays. At the same time, lower price movements were also observed when large amounts were traded during the 4pm Fixing window compared to other times of the day. This was observed at month-ends as well as other days. One member commented that demand for matching buying and selling interests to be traded at the fixing had recently risen to a record high. Members asked if such developments were healthy for the market, particularly given the high volume of algorithmic trading taking place around these points during the day and the fact that, in the past, trading at the fixing was prone to manipulation. The guest speaker on the topic felt that the governance and surveillance around the current benchmark calculation

methodology were robust and created trust in the integrity of the benchmarks. Future improvements to the benchmark calculation methodology would be possible, following a careful assessment of feedback from a broad set of market participants.

3. Work programme of the FXCG in 2022

The FXCG Secretariat presented the draft work programme for 2022 and invited members to provide additional ideas for topics by the end of the week.

4. Any other items

The Chair reminded members that their contributions to the GFXC survey on work priorities would be highly appreciated by the indicated deadline.