

Foreign Exchange Contact Group (FXCG)

Frankfurt am Main, Thursday, 5 May 2022, 14:00-16:00

SUMMARY OF THE DISCUSSION

The Chair of the FXCG welcomed Ms Andréa Maechler, the new Chair of the Global Foreign Exchange Committee (GFXC), who was attending the meeting as a special guest. Ms Maechler outlined the key priority areas for the future work of the GFXC, with more details expected at the forthcoming GFXC meeting on 27 and 28 June 2022. Several members felt that the electrification of FX trading, digital currencies and the growing use of distributed ledger technology in settlement should also be given attention in future discussions.

The group then discussed recent developments in the FX market, the outlook for major currency pairs, and liquidity conditions in the FX spot and derivatives segments.

1. Review of recent market developments and outlook

Mr George Saravelos, an FX strategist from Deutsche Bank who was attending the meeting as a guest speaker, presented an assessment of the current FX market environment and the outlook for major currency pairs.

He felt that the period of low volatility in FX markets was over and a regime shift was under way. Quantitative analysis suggested that the most significant driver of FX market volatility was generally the pace of global economic growth – more so than monetary policy divergence, which had driven the performance of G10 currencies. Periods of positive growth tended to be associated with low levels of FX volatility, whereas the slowdown that market participants now expected to see had the potential to usher in a prolonged period of higher realised and implied FX volatility. One participant commented that the FX market's reaction to the end of the low-volatility era had so far been delayed, and then very abrupt.

The support that the Federal Reserve's tightening had given to the US dollar was expected to weaken going forward. In his presentation, Mr Saravelos explained that current market pricing was close to the perceived terminal rate for the Federal Funds Rate, which left little room for further hawkish surprises in support of the US dollar. In addition, the US dollar had, historically, tended to retreat shortly after the start of a rate hike cycle. The main upside risk to this view for the US dollar stemmed from a shift to a higher terminal rate, which had the potential to result in a tightening cycle more akin to 1984, when the US dollar had continued appreciating well into the rate hike cycle. Quantitative tightening by the Federal Reserve was regarded, *ceteris paribus*, as reducing the need for aggressive rate hikes, leading to lower yield differentials between the United States and the rest of the world. The relationship and trade-off between the dynamics of quantitative tightening, interest rate hikes and exchange rates were seen as applying to the euro and the ECB as well.

The euro, in contrast, had the potential to benefit from a further shift in expectations regarding ECB rate hikes. The terminal rate was regarded by Mr Saravelos as being higher than current market estimates. One risk on the upside related to a potential reversal of portfolio flows back towards the euro area when interest rates cease to be negative. Mr Saravelos also felt that the European equity positions which had been overweighted at the end of 2021 had already been cleared and that, if anything, global asset managers were looking for an opportunity to add European holdings to their equity allocations. The main risk on the downside stemmed from the effect of the conflict in Ukraine and commodity price

developments. Market positioning as regards the euro was assessed as being short, but not extreme, so it was considered, on balance, to be supportive of a possible rebound in the euro going forward.

The pound was regarded as remaining vulnerable. Its recent depreciation had the potential to continue, as it was felt that the Bank of England would tighten policy by less than had been priced in by the market, owing to concerns about slowing growth and reduced competitiveness as a result of Brexit.

Emerging markets (with the exception of China) were seen as being better protected against outflows than they had been in past Federal Reserve tightening cycles. This perceived resilience stemmed from the fact that most emerging markets' central banks had already started raising policy rates last year, narrowing the interest rate differential relative to the United States.

The discussion on FX market volumes revealed several possible scenarios as regards the effect that shifts in global economic ties and the increased focus on "friend-shoring" would have on FX. It was thought that one scenario – termed "China plus one" – could see firms shifting part of their production to other third countries, giving rise to increased demand for those countries' currencies.

2. Update on FX trading activity

Mr Jeff Ward (EBS) provided an overview of recent trends in trading volumes and liquidity metrics for the euro, the Japanese yen, the Chinese renminbi and the Russian rouble.

He explained that the rise in volatility had resulted in a corresponding increase in average daily trading volumes. Since the invasion of Ukraine, the increase in volatility had also been accompanied by a shift away from relationship-based trading and concentration around the most commonly used primary central limit order book platforms.

Bid-offer spreads had widened in response. Several members observed that liquidity in FX derivatives and the funding of FX transactions had become more challenging, particularly for emerging markets' currencies. Some members highlighted the growing funding costs in the FX swap segment. These were only creeping up, but they had the potential to become a bigger issue if counterparty credit risk concerns increased (e.g. in the presence of market stress).

The Russian rouble market was broken. Liquidity in the Russian rouble remained well below pre-invasion levels, with activity concentrated mostly among larger banks in offshore markets (outside Russia and in a few non euro-area jurisdictions which do not enforce sanctions) and virtually no trading being conducted by other types of participant.