

Foreign Exchange Contact Group

Frankfurt am Main, Thursday, 16 November 2023, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of the recent foreign exchange developments and outlook

Yasemin Artar (HSBC) and Alexandre Dubé (Total) reviewed recent developments in the global foreign exchange (FX) market.

In general, liquidity conditions and market functioning in the foreign exchange market have improved in the fall of 2023 and remained orderly. FX implied volatility in G7 currencies has decreased, seemingly due to a diminished likelihood of significant risks materializing and anticipations of the end of the global monetary policy tightening cycle. In particular, the U.S. Federal Reserve's shift towards a less hawkish monetary policy stance and the gradual adjustment of the Bank of Japan's Yield Curve Control policy were seen as contributing to lower volatility, also going forward. At the same time tighter spreads in both spot and FX futures markets have all contributed to better liquidity for both G7 and emerging market currencies. While the US dollar strengthening has led to some increased volatility in emerging market currencies, the conflict in the Middle East has not had a significant impact on the liquidity of FX markets overall. FX futures have continued to gain prominence as the primary FX trading instrument versus cash transactions. In a bigger picture, stronger developments in regulatory equivalence between different jurisdictions was seen as an important element to ensure global FX liquidity and moderate trading costs in the future.

Views on the euro outlook were divided. A continued divergent growth outlook for the euro area and US was seen by some members as weighing negatively on the euro as global growth dynamics, risk sentiment, easing supply chains and falling energy prices seemed to be less supportive for the euro. Some members viewed US Treasury bond market developments as the primary driver of the US dollar exchange rate going forward with the Fed's less hawkish monetary policy stance, softening US employment data and downward inflation trends indicating a weakening of the US dollar going forward. Views on the Japanese yen were also mixed with some members anticipating a strengthening of the Japanese yen driven by a narrowing of interest rate differentials. In contrast, some other members emphasized a more "event-driven" outlook, suggesting that an accelerated shift in monetary policy would be necessary for the Japanese yen to strengthen. The BoJ exit from accommodation was

described as disappointingly gradual and deemed favourable for carry trades funded with the yen. However, there is a concern that a sudden change in BoJ policy could jeopardize these trades.

When looking at near or medium-term key risk events, FX option pricing points out uncertainties around both Bank of Japan's monetary policy meetings and the US Presidential elections for G7 currencies, the latter also for emerging market currencies. However, with the latest Fed communication, the overall risk picture for early 2024 seemed to have moderated.

In the oil market, the conflict in the Middle East heightened the geopolitical risk premium on oil prices, particularly if the conflict were to escalate in the short term. The base case for the oil price outlook was seen moderate, but the tail risk under-priced.

2. Managing the T+1 securities settlement transition

Martin Knudsen (Bloomberg) and Myriam Sifaoui (Société Générale) highlighted considerations for the transition of the standard settlement cycle for US securities from two business days (T+2) to one business day (T+1) on 28 May 2024.

Members agreed that the transition to T+1 securities settlement in May 2024 adds complexity and costs, presenting ongoing challenges for market participants.

Inadequate preparedness by non-US based counterparties, vendors, custodians, settlement and clearing service providers increases the operational risk. Members have raised a notable concern regarding the necessity to reassess the existing netting process. This could elevate pre-funding requirements, leading to increased costs for both the buy and sell side, as there would be greater utilization of counterparty limits and funding.

The EU is expected to gradually contemplate to shorten the securities settlement cycle also in EU, but the process will likely proceed at a measured pace. The UK, on the other hand, is further along in its political debate, indicating that the shift might happen sooner. Members highlighted that if the UK embraces the change, the impact on Europe could be substantial, considering the widespread sharing of technology and settlement practices among EU companies. This could prompt an acceleration consideration to move to similar T+1 securities settlement convention also in the EU.

Members suggested that complexity in managing the settlement risk lies in the fact that different jurisdictions are involved. In this context it was mentioned that some market participants might have considered moving certain FX activity to North America to better cope with T+1 trading and settlement. In a broader context, it was also mentioned that achieving regulatory equivalence among various jurisdictions for different FX vendors was a crucial

element if European and global FX markets wish to safeguard global FX liquidity and manage trading costs effectively.

3. Triennial FX Global Code Review

The Group was informed that the Global Foreign Exchange Committee (GFXC) will undertake a three-year review of the FX Global Code in 2024, to ensure that the Code keeps pace with the evolution of the FX market. The plans for the review will be discussed at the GFXC meeting in the end of November. In advance of this, the GFXC has sought feedback and encouraged members of local Foreign Exchange Committees to provide their opinions on the priorities for the review. The GFXC had also launched its annual survey of market participants, which provides an important opportunity for all market participants to make their voices heard and continue to shape the Code in a way that reflects diverse viewpoints.

The Group had a discussion on the effectiveness of the latest updates and potential areas of focus for the next review. In summary, members felt that the Code remained fit for purpose and did not require a fundamental or comprehensive revision, although some target areas were still identified for further guidance and improvement.