EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Thursday, 22 September 2022, 14:00-16:00

SUMMARY OF THE DISCUSSION

1. Review of recent markets developments and market conditions

James Malcolm (guest speaker from UBS) reviewed recent developments in the foreign exchange (FX) market. Peter Vincent (State Street) presented market conditions in a higher volatility and interest rate environment.

Currently, the FX market is characterised by a significant US dollar strength. Market drivers of exchange rates have shifted since last year from relative growth and inflation dynamics to uncertainty of the rates and economic outlook. The US dollar is supported by the prevailing risk aversion and the US energy position provides a certain degree of insulation of the US economy to the energy crisis. The euro is weighed by the energy crisis and by low front-end real rates.

Indicators of investors' FX holdings show a considerable dollar overweight compared to other developed markets currencies. The indicators also show a significant underweighted investor position in the euro and in most emerging market currencies.

Data showed that FX trading conditions have improved since the Russian invasion of Ukraine. FX trading volumes recovered quickly after the invasion in February and have returned close to longer-term average levels. Spot market liquidity in terms of order book depth has been more robust than in 2020 amidst a mild widening in bid-offer spreads, while FX swap market liquidity was seen as poor with price gapping.

The group discussion centred around major currencies. The US dollar was viewed as at or near its cyclical peak, though several participants thought it could strengthen further in case of a more severe global economic downturn. If the euro area economy withstands the winter well, combined with a potential peak in the US rate hike cycle, the euro could moderately recover. Members noticed that the FX intervention by Japanese authorities (on the same day as the FXCG meeting) was accompanied by significant trading volumes and a sharp decline in the USD/JPY exchange rate. While acknowledging the sizeable amount of Japan's foreign reserves, predominantly held in US dollar, it was mentioned that it could take months before the Japanese yen strengthens sustainably. Some members considered the British pound vulnerable given a relatively less hawkish monetary policy stance combined with accommodative fiscal policy, high inflation as well as current account and fiscal deficits. Members also noted that the Chinese renminbi has depreciated markedly against the US dollar, but the CFETS currency index is still at strong levels as other currencies have weakened comparatively more.

2. Environmental, Social and Governance aspects in FX markets

Clara Williams (guest speaker from BNP Paribas) gave an overview on Environmental, Social and Governance (ESG) aspects in FX markets. The FX Global Code has been an important initiative in recent years to promote ESG from a governance perspective, although in her view greater adoption of the Code from the buyside should be a priority. Anti-money laundering regulation has also clear ESG implications as environmental crimes and human trafficking are two of the most significant crimes associated with money laundering. She also mentioned the increasing interest to incorporate sustainability elements into official institutions' reserve management. But there have so far only been few bespoke ESG-associated FX market transactions where pricing has been linked to clients' ESG ratings or meeting ESG targets.

The group discussed the challenges to incorporate ESG into FX. Trading in FX is a high volume, low margin business which mainly functions as a neutral, auxiliary vehicle between portfolio transactions. This makes it difficult to develop FX products that are either "green" or "social." Members also found the lack of a common understanding on what constitutes adherence to ESG to be a bottleneck, even though various initiatives to clarify such uncertainties are being worked on. This has meant that the few ESG-linked FX transactions have been costly with a high degree of manual handling inhibiting the market's ability to scale such transactions.

3. Other items

Chair Toto Silvonen reported on the Global FX Committee's June Meeting. The work programme aims to broaden the motivation for adherence to the Code and find ways to clarify proportionality issues. The GFXC will also continue exploring data accessibility and payment and settlement issues. Members exchanged views on how to further promote the Code and were encouraged to give feedback to two ongoing public consultations: on pre-hedging by the European Securities and Markets Authority (ESMA) and on facilitating increased adoption of payment versus payment by the BIS Committee on Payments and Market Infrastructures (CPMI).