EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Thursday, 22 June 2023, 14:00-18:00

SUMMARY OF THE DISCUSSION

1. Review of recent markets developments and market conditions

Peter Vincent and Tim Graf (State Street) reviewed recent developments in the global foreign exchange (FX) market.

Overall, the FX market has functioned well, market conditions and liquidity for G10 currencies were viewed as improved and healthy. FX implied volatility in G10 currencies has fallen to historically low levels but spot trading volumes in G10 currencies have remained surprisingly low. According to one member relatively small currency movements owe to central bank monetary policy synchronization and the lack of strong conviction among investors, which is demonstrated by the low level of volatility and volumes. Moreover, uncertainty about future monetary policy of the Bank of Japan was told to limit potential carry trades involving the Japanese yen and reduced risk-taking appetite in this currency pair. Emerging market currencies have shown greater trading volumes. In the FX options market, investors' positioning has indicated little directional guidance, except ahead of key macroeconomic data releases and monetary policy announcements. Flows into euro government bonds and equities were told to have remained high, with a significant portion of these transactions being hedged. During the discussion members stressed the importance of central bank swap lines, which serve as a valuable safeguard during periods of financial stress. At the same time, members mentioned that utilization of swap lines by market participants had remained low due to steady FX market conditions but also highlighted concerns about reputational risk of too early use. Instead, banks opt to borrow foreign currency on secondary market, even at a higher cost.

2. Managing the settlement risk

Stéphane Malrait (ING), Andrew Harvey (GFMA) and Janusz Ryzner (ECB) informed members about the US Securities and Exchange Commission's initiative to shorten the standard settlement cycle for US securities trades to one business day. Maria Dolores

Delgado (ECB Banking Supervision) presented analysis of the FX settlement exposure for a sample of supervised banks.

Members were informed that also the Global Foreign Exchange Committee (GFXC) had discussed this topic in its June meeting in the context of FX settlement risk[1].

A few members felt that shortening of the settlement cycle to t+1 raised some concerns, particularly for some regions with narrow time window with the US trading hours and for some types of FX market participants which do not settle through Continuous Linked Settlement (CLS). Members felt that in order to manage increased operational risk, it was important to ensure that the timing of FX and US security trades align closely to minimize the risk of missing the CLS cut-off time for the related FX transaction. They also highlighted increased costs associated with new processes, e.g., pre-funding (increased need for liquidity where in some members‘ view custodians should play a bigger role), late payment fees, system enhancements, and higher likelihood of errors.

One member underlined that with the use of latest technology one could achieve timely settlement without settlement risk by blocking trades simultaneously and in this way even eliminating the need for CLS. This could be useful for a buy side and smaller market participants which are unable to utilize CLS due to various constraints, including high costs. One member felt that market participants might be less inclined to seek liquidity for pre-funding from their deposits or investments in a higher interest rate environment. Another member told that banks (in general sell-side) try to proactively settle via Payment-versus-Payment procedure but encounter resistance from large corporates and asset managers for which both cost, and liquidity are constraints. Overall members felt that shortening the US securities settlement to t+1 will be challenging and raises settlement risk. Members also appreciated the update and the exchange of views with the SSM representative.

3. The international role of the euro

Peter McQuade (ECB) presented the key findings of the annual review on the international role of the euro.

During the discussion, members mentioned that the ongoing geographical regulatory divergence could have influenced the FX market activity in the aftermath of Brexit. One member noted that data on the geographic location of transactions may be less meaningful in an era of electronic payments and wondered the importance of this type of breakdown in the future. Regarding the reported global accumulation of gold reserves by official sector,

[1] https://www.globalfxc.org/events/20220627_minutes.pdf

participants discussed the significance and interpretation of this trend with geopolitical development.

4. Debriefing about Global FX Committee meeting and the new proportionality self-assessment tool

The ECB informed members about the key takeaways of GFXC meeting on 1-2 June and demonstrated how the recently launched Proportionality Self-Assessment Tool looks like. The tool has been developed to support the process of identifying which of the 55 principles of the FX Global Code are most relevant to different FX market participants based on their activities in the FX markets and it has been made available on the GFXC website.