EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Exchange Contact Group

Frankfurt am Main, Wednesday, 20 June 2018, 14:30-18:00 CEST

S U M M A R Y O F T H E D I S C U S S I O N

1. Update on FX Global Code and Global FX Committee work

Roswitha Hutter (ECB) presented the current status of the adherence to the FX Global Code and the Global FX Committee (GFXC) work. Members agreed that, one year since the launch of the Code, a significant number of market participants from around the world, most notably banks, have endorsed the Statement of Commitment to demonstrate their adherence to the Code. Members acknowledged that the Global Index of Public Registers, recently launched by the GFXC, constituted a helpful tool in gauging market adoption of the Code and an incentive for other peer competitors to follow suit. In that respect, the members considered that further effort should be made to promote a broad adoption of the Code by raising awareness among certain market participant categories, particularly in the asset management and hedge fund communities.

The members discussed the current GFXC priority working areas: (i) negative examples related to Principle 11 of the Code on pre-hedging activity, (ii) “cover and deal” type trading activity, and (iii) disclosure and transparency. Members expressed a wide variety of opinions on the draft examples related to pre-hedging activity and brought up various issues that may impact the notion of pre-hedging, such as size of order, existing inventory and intent. Members expressed, on the one hand, their preference for simpler and more realistic scenarios and, on the other, their preference for a larger number of more specific examples in order to bring clarity to the market and facilitate a convergence of views, even though obtaining consensus on such examples will be challenging. A majority of members felt that further work could help improve the clarity of the examples and reduce the risk of misinterpretation. Moreover, members supported further work in the areas of “cover and deal” type trading activity, and disclosures and transparency.

2. Structural evolution of FX market trading and FX liquidity

Adrian Boehler (BNP Paribas) gave a presentation on the structural evolution of the FX market and FX liquidity. The FX market is in a state of transition in which MiFID II and the FX Global Code have increased the focus on best execution, transparency and disclosure and is moving towards more auditable and measurable automated FX workflows. The degree of electronification is increasing, which is contributing to making the FX market more fragmented owing to the growing number of trading venues.

Members generally agreed that the pace of change still seems to be accelerating and that further automation and more sophisticated transaction cost analysis will be among the factors dominating market evolution going forward. In this environment, algorithmic execution has seen a notable rise in activity since the beginning of 2018. Clients seem to appreciate this broader choice of execution methods and are more willing to hold market risk while reducing transaction costs. This may lead to further downward pressure on profitability in market-making businesses, resulting in renewed consolidation and retrenchment amongst traditional sell-side liquidity providers.

The growing number of trading venues was seen as consistent with further diversification in trading flows, with rising FX futures volumes on regulated exchanges. Regarding FX liquidity, the general widening of bid/offer spreads following the removal of the EUR/CHF floor in early

2015 has now largely been unwound, partly on the back of reduced market volatility. In recent months, bid/offer spreads have continued to decline more for top-of-book orders than for orders in lower tranches, which is potentially consistent with growing algorithmic trading.

3. FX Outlook: Review of FX markets developments and outlook

Alan Stewart (Goldman Sachs) presented a review of recent FX market developments and the market outlook. In his view, the decline in the EUR/USD rate in April and May 2018 is consistent with the wider interest rate differential between the one-year/one-year EONIA and USD OIS rates. The picture of synchronised and robust global growth is challenged by growth indicators suggesting a deceleration in the euro area compared to other regions. This, coupled with a downward revision of euro area growth expectations, was perceived as a headwind for the euro.

The recent reduction in US dollar short positioning has been moderate, as it only brings the market positioning back to early 2018 levels. Leveraged funds have recently turned mildly net short in euro, while non-commercial investors and other asset managers have scaled back their net long euro positions. FX volatility continues to be low compared to other asset price volatilities, while the outlook on FX market volatility is rather uncertain as global excess liquidity is further scaled back.

During the discussion, the FX market was said to be well-functioning amid the heightened Italian political risks in May which caused the Italian sovereign bond market to experience high intraday volatility.