



EUROPEAN CENTRAL BANK

EUROSYSTEM

FX swap market: Recent trends, underlying factors and possible future risks

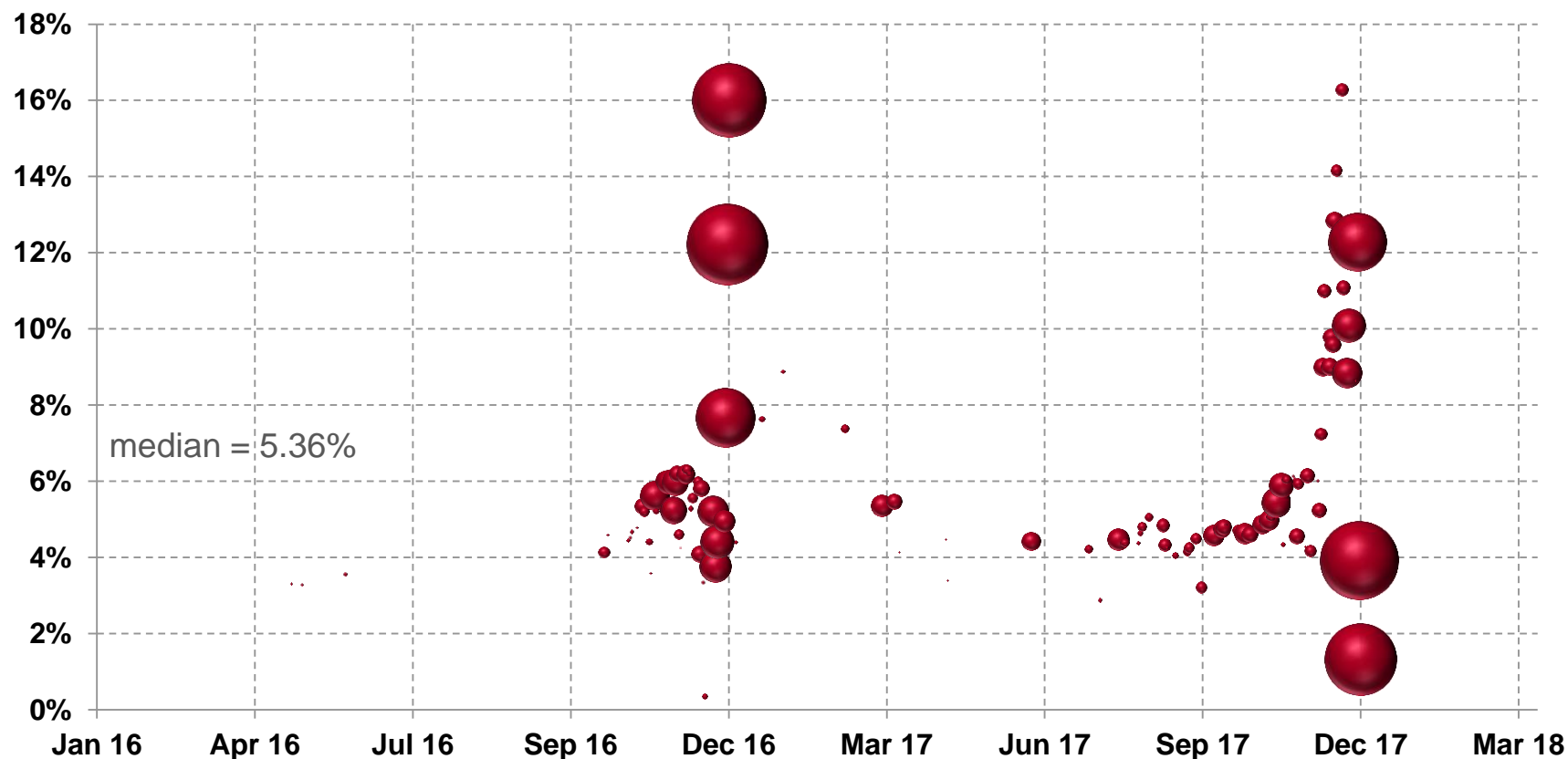
Dimitrios Rakitzis (ECB)

ECB FXCG, 20 March 2018

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USD funding premium at the turn of 2017 set in earlier, lasted longer, but peaked lower compared to end-2016

Weighted average FX swap implied rates in % and relative volumes traded daily for year-end 2016 and 2017



Source: MMSR data and ECB calculations

Notes: Bubbles (one per trade day) show weighted average implied rates paid by MMSR banks in the FX swap market when borrowing US dollar. Bubbles are scaled by the volume of transactions on the day (bubble size). All trades are forward dated, i.e. have a settle date up to 1 week before YE and maturity date up to 1 week after YE.

Market participants at that time mentioned a number of potential drivers

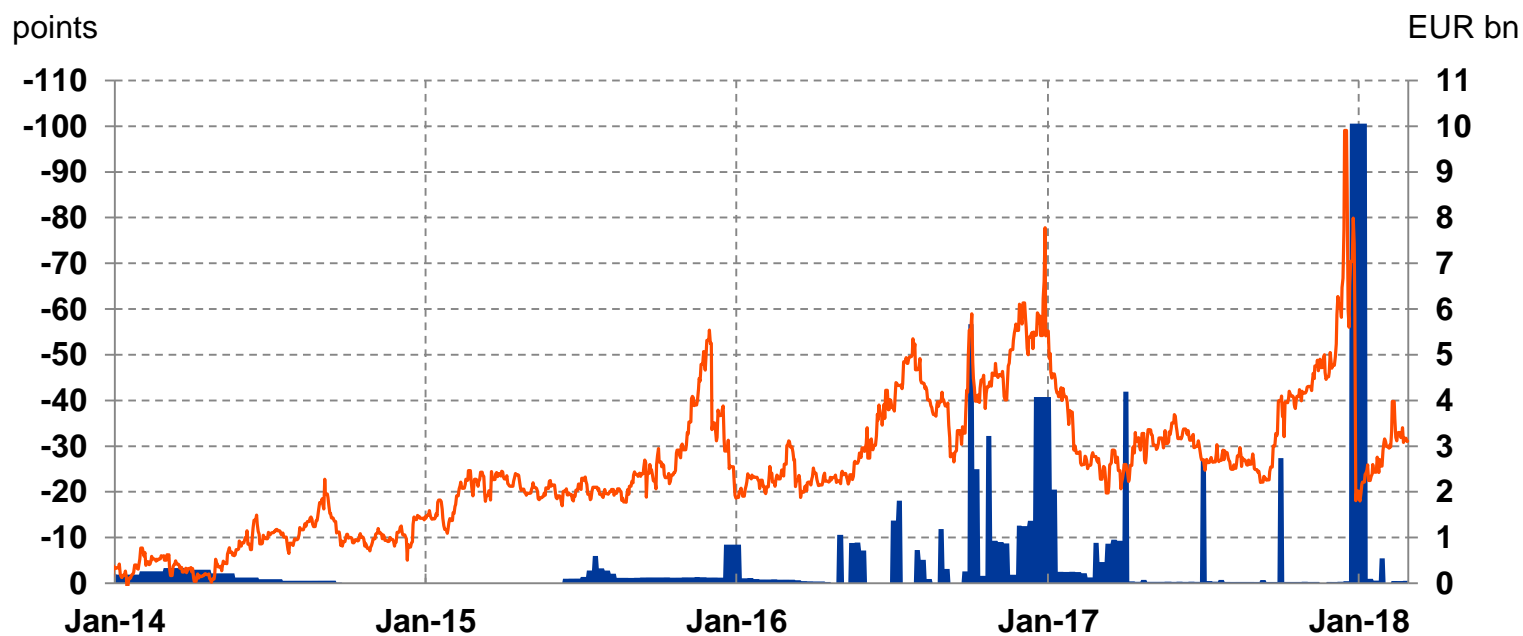
- **Supply shock:** Less supply by US banks that worry about their G-SIB ranking and (additional) institutions in the 2018 CCAR;
- **Demand shock:** unexpected, large one-way transactions have an immediate impact on the USD premium;
- **Regulation:** European banks tightly managing their balance sheets ahead of year-end, thus reducing traded volumes;
- **MiFID II:** Uncertainty about the state of bank preparedness (effective as of 3 Jan. 18) might have affected market behaviour
- **USD specialness:** FX balances easiest squared against USD;

➤ **What about the Eurosystem's USD operation?**

Participation at the ECB 1-week US dollar operations covering year end increased

- **Participation:** 21 banks bid for USD 11.9 bn, vs. 12 banks for USD 4.3 bn at end-2016;
- **'Moneyness':** the operation settled at 1.89%, some 174 bps below the weighted average cost paid in equivalent maturities by MMSR banks

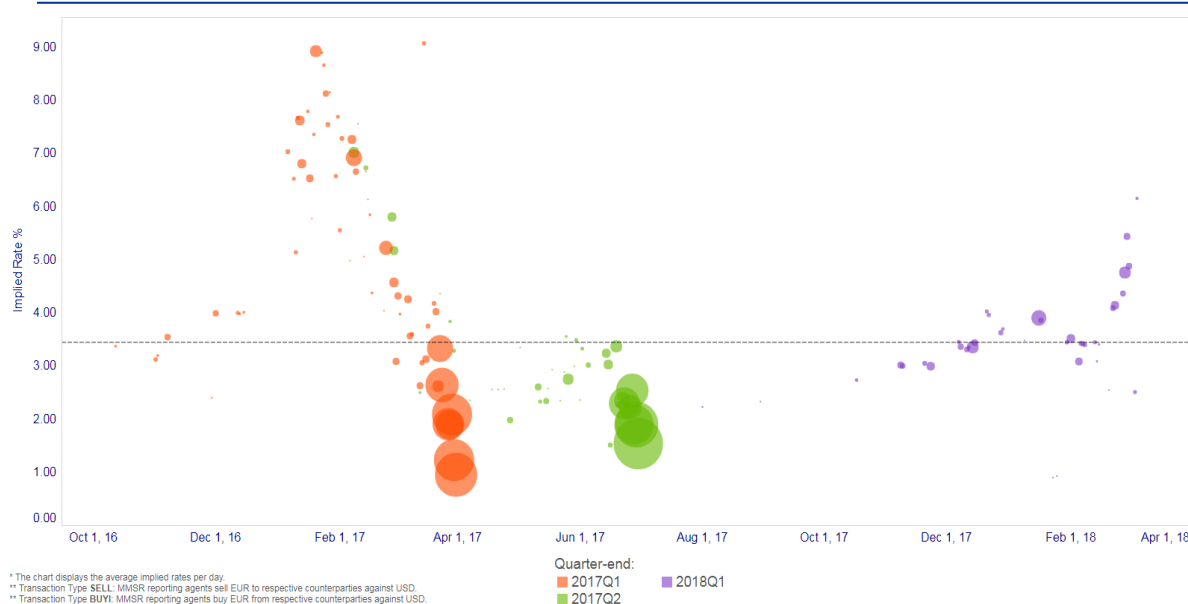
USD swap market tensions (EUR/USD cross currency basis swap) and the ECB's USD tender



MMCG market participants suggest that there are factors pushing the USD funding cost via the swap market higher since early 2018

- Driving factors primarily attributed to the US domestic developments:
 - Unwinding of the Fed's balance sheet and FOMC tightening cycle.
 - Higher issuance of T-bills by the US Treasury,
 - Tax repatriation flows by US corporates,
- Going forward, this may lead to a further tightening of the USD funding conditions both in the US and abroad.
- ECB USD operations are a backstop, but allotment volumes not commensurate with market size.

Weighted average FX swap implied rates in % and relative volumes traded for quarter-ends



Source: MMSR data and ECB calculations

Notes: see slide "FX swap market tension on balance sheet reporting dates"

Issues for discussion

- 1. What will be the main FX market drivers and risks in coming months?**
- 2. Why did the spike in equity market volatility not spill over more prominently to the FX market?**
- 3. Beyond market funding cost, what other factors determine bank participation to the ECB's USD tender?**
- 4. What are the drivers and implications from the recently widening USD FRA OIS spreads for banks in Europe/USA?**