Minutes of the Canadian Foreign Exchange Committee

12:00 – 14:00
16 November 2022
CIBC Capital Markets

Present:
Stephen Best, Refinitiv
Christine Bourgeois, Caisse de dépôt et placement du Québec
Dagmara Fijalkowski, RBC Global Asset Management
Lorne Gavsie, CI Global Asset Management
William Kellett, Scotiabank
Peter Kalamvokis, TD Securities
Russell Lascala, Deutsche Bank
Jim McCrindle, Bank of America
Manuel Mondedeu, CIBC World Markets
Charles Perreault, Department of Finance, Canada
Gaétan Reid, State Street Global Markets
Elizabeth Steele, HSBC Bank Canada
Miro Vucetic, Citibank
Jean-Philippe Blais, BMO Capital Markets
Chris Soriano, CME

Grahame Johnson, Bank of Canada (Chair)
Zahir Antia, Bank of Canada (Secretary)
Harri Vikstedt, Bank of Canada
Wendy Chan, Bank of Canada

External speakers:
Avery Shenfeld, CIBC Capital Markets

The meeting was conducted in-person with a video-conference option.

1 Adoption of Agenda

The Committee adopted the agenda as written.

2 Update from the New York FX Committee

The Chair informed members that due to unforeseen circumstances, the update by the New York FX Committee will be postponed to a future meeting.

3 Economic outlook

Mr. Avery Shenfeld, Chief Economist at CIBC Capital Markets, presented his views on the Canadian economy. He noted that the monetary policy tightening by the Bank of Canada in 2022 is starting to have an impact on macro-economic conditions. The pace of economic growth in Canada is slowing, tightness in the labour market is easing, and inflation is declining. He expects annual GDP growth in Canada will be below 1 per cent in 2023 with the economy possibly stalling or contracting modestly for a few quarters. He expects the inflation rate will decline closer to the Bank of Canada’s target range by the end of 2023, reflecting weak economic growth, moderating wage pressures, and easing supply constraints. These factors suggest the Bank will not have to raise interest rates much higher to bring inflation down. He expects the Bank of Canada to raise interest rates by an additional 50 basis points and then pause its interest rate hiking cycle. He acknowledged that if inflation does not fall as expected, interest rates may need to rise further, which could likely lead to a more protracted economic slowdown than forecasted.

4 FX market conditions

Members discussed the main drivers behind the recent moves in exchange rates. One member noted that the US dollar, which has appreciated sharply this year, could have reached a cyclical peak. The US dollar has retreated from its highest levels against many major currencies. The main drivers of US dollar strength, such as the aggressive interest rate increases by the Federal Reserve and broader risk aversion, appear to be moderating. The market is pricing in a slower pace of interest rate increases by the US central bank. Global risk aversion also appears to be receding. Unwinding of extreme long US dollar positions is further contributing to the recent weakness in the currency. However, positive [real] interest rate differentials against most other countries should provide support to the dollar. Members were a little more cautious on the outlook for the Canadian dollar due to the expected weakening of the Canadian economy. However, it was noted that the Canadian dollar remains one of the best performing G10 currencies against the US dollar this year. One member indicated that liquidity in the Canadian dollar has remained fairly resilient, despite the market volatility.

One member provided an update on FX swap funding conditions into year-end. He noted that the FX basis swap market was pricing in a premium to borrow US dollars over year-end. However, the premium had come off its highest levels in most cross-currency pairs. Regulatory policies that incentivize banks to reduce their balance sheets at the end of the year appear to be the main drivers behind higher funding costs. Members expected some additional funding pressures going into the end of November, after which they were expected to ease.

5 December GFXC meeting preview

The Secretary provided members an update on the (virtual) GFXC meeting which will be in December. The meeting will focus on increasing buy-side adoption of the Code. The two working groups (WG) - the Proportionality WG and the Motivation for Adherence

WG - will provide an update on their progress. There will also be a discussion on the availability and policies around FX market data. The meeting will include a presentation by the ACI FMA on its ELAC Portal for the FX Global Code, and by the BIS on its work on Alternative Technologies for FX Trading and Cross Border Payments. Finally, there will be a discussion on FX market conditions.

6 BIS Triennial Survey overview

The Secretary provided a summary of the recently concluded BIS Triennial Survey on FX and OTC derivatives turnover. Turnover in OTC FX markets totaled $7.5 trillion per day in April 2022, up 14% from $6.6 trillion three years earlier. Average daily turnover in Canada increased from US$109.1 billion in 2019 to US$172 billion. The increase was driven mainly by an increase in FX swap volumes. Turnover of OTC interest rate derivatives averaged $5.2 trillion per day in April 2022, less than in April 2019 ($6.4 trillion). Interest rate derivatives turnover in Canada in April 2022 decreased by 32 percent to US$1.4 trillion from the US$2.2 trillion recorded in 2019. The decline in OTC derivatives turnover is due to the sharp decline in LIBOR based Forward Rate Agreements as the market transitions to risk-free rates.

7 The impact of Bank of Canada's balance sheet on the banking system

The Chair of the Committee presented his recent "Staff Analytical Note" on the affect of quantitative easing (QE) and quantitative tightening (QT) on the balance sheets of the Bank of Canada and the overall banking system. The direct effects on the size, composition and liquidity of the banking system's balance sheet during QE and QT depend on who - banks or non-bank participants (such as households, businesses or investment funds) - sells (during QE) or buys (during QT) Government of Canada (GoC) bonds in the financial system. During QT, the effect will be greater if non-bank participants replace the Bank as the marginal buyer of GoC bonds. This is the most likely scenario since historically, non-bank participants have held a significant share of the GoC bond market. As well, during QE, the Bank primarily displaced these entities in terms of GoC holdings. He noted that the analysis focuses exclusively on the mechanical impacts of QE and QT. Other factors that could influence the size and composition of commercial banks' balance sheets, including natural growth in bank deposits, loan growth and changes in the level of government bond issuance, are held constant

8 CARR update

Mr. Harri Vikstedt, Co-Chair of CARR, informed members that the working group was engaging with the Montreal Exchange to develop liquid 1-month and 3-month CORRA futures contracts. The 1-month CORRA futures is expected to be launched early in 2023. He also reminded members that Bankers Acceptances (BA) will likely stop being issued after June 2024 with the cessation of the publication of CDOR. The Bank of Canada will publish a White Paper summarizing the results of a series of workshops on the potential implications of the cessation of CDOR on the BA market in early 2023.

9 Other business

Members were informed that the GFXC leadership plans to meet with ESMA to share its perspective on pre-hedging in response to ESMA's "call for evidence on pre-hedging".

The Secretary will work with members to identify dates for CFEC meetings in 2023.