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Speech

Foreign Exchange as a Business in the 21st Century

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Foreign Exchange as a Business in the 21st Century

It's a great pleasure for me to be here today, to kick off this inaugural 'Forex Forum' by giving what is rather grandly described as a keynote address. My interpretation of this task, however, is much more down to earth. To me, a keynote speaker should act like a trailer in a cinema: advertise what is to follow, but under no circumstances delay the main feature for too long. I will try to fulfill this simple task today.
First, though, I'd like to start by saying a bit about the role of the Foreign Exchange Division at the Bank of England. My job covers a wide range of markets: foreign exchange, overseas money and bond markets, and gold. But it also covers a wide range of functions. We provide information and advice to policymakers. We advise on financial stability issues, remaining alert to stresses in credit and other markets. I chair the foreign exchange Joint Standing Committee, which brings together many of the leading practitioners in London, not just bankers and brokers but also the Association of Corporate Treasurers. And finally, we carry out transactions for our government and central bank customers, and act as investment managers for the UK government, with a portfolio totalling $43 billion at present. It is these latter roles which give us a perspective on foreign exchange, not only as policy makers, but also as users of the market. It is from this vantage point that I want to talk to you today.

The fx market is huge: the BIS survey back in 1998 suggested turnover of $1.5 trillion a day, of which a third was in London. What is needed for such a market to work effectively?

First, there must be an underlying need to transact (related, for instance, to trade, M&A, or portfolio flows).

Second, participants must have differing views, so that one party is prepared to take the opposite side of a trade.

Third, those with the views need to have an appetite for risk, so that these differences in view are translated into action.

And finally, both liquidity and technology are important as enablers, so that all of this happens efficiently and effectively.

This conveniently foreshadows many of the topics which will be dealt with by the roundtables later today. And that, as I said at the start, is what a keynote address should do!

Let me start by listing a number of propositions:

There will continue to be a need to transact in fx. Other things being equal, globalisation leads to an increase in foreign exchange flows. World trade continues to grow much faster than world output, and capital flows have increased enormously, as companies and investors have diversified their activities. Whether M&A flows will continue to increase at recent rates remains to be seen, but there is little sign more generally of capital flows shuddering to a halt. Of course, the creation of currency zones, such as the euro area, reduces the need for foreign exchange, as do decisions by firms to transact in only one currency, such as the dollar. Nevertheless, foreign exchange is not about to become extinct.

Next, I said earlier that for a market to thrive, individuals need to have differing views. Will this continue? At present "Follow thy neighbour" seems to be the fashion, rather than taking an independent view, and this is a point to which Herve Ferhani will return in his closing address later today. Nevertheless, I am sure that the roundtable discussions will conclude that the clients of the future will differ in their views as well as their needs, and that end-users will continue to expect FX forecasters to have views! But views are not enough, without the capital to support them. And there has been a reduction in risk capital employed in foreign exchange in recent years. This need not last forever: it reflects relative risks and returns in this area as compared with others. And one could certainly argue that at times in the past we have had too much capital devoted to market-making at least; six or seven years ago there were scores and scores of banks who all wanted to be in the 'Top 10' for foreign exchange.

My third proposition is that the nature of liquidity has changed over the years. This is the subject of a roundtable debate later today, but I will come back to this issue myself shortly.

Finally, there is an interesting debate about how far technology will provide greater transparency, both on pricing and costs, and whether this will lead to the sort of unbundling we have seen in apparently unrelated businesses such as the airlines industry. Again, I'll come back to this later.

But first, let's look at liquidity for a few minutes.

Liquidity clearly ain't what it used to be. But it is much less clear what such a statement means, still less whether that is a 'good' or a 'bad' thing. For instance, there are now fewer market makers, in part because of consolidation and in part because the returns to the business for many players have been insufficient to justify the risks they took. Is such an outbreak of rationality a bad thing? Not obviously so. Nor is the realisation that the provision of liquidity is a service for

which users, even sadly central banks on occasion, must be prepared to pay. Put crudely, liquidity is still available; the question is at what price.

Next, it is far from straightforward to know whether liquidity has indeed fallen. If liquidity is defined as the ability to execute a sizeable trade without moving the price against you, then turnover clearly measures this rather poorly and 'normal' spreads, though better, are also not ideal. What is clear is that accessing liquidity requires different skills now than five years ago. And as electronic trading comes of age in the customer market, we will see a growth in what one might call 'patient' trading for large orders, and perhaps a continuation in the recent trend for users to give orders to trade 'at the market' rather than at a given price.

Finally, all of us, whether banks or end-users (and as I say, the Bank of England is a mixture of both) will have some concerns about liquidity illusion: the risks which arise from building up a position in the mistaken belief that it can be run down in all circumstances at little or no discount to the market price. Jim Trott, our recently retired Chief Dealer, once sagely observed, 'there's almost unlimited liquidity in the market when you are wrong'. This unlimited liquidity will disappear if you, like everyone else, are trying to cut the same position. This is an important issue, and deserves a rather more interesting title than 'liquidity illusion risk'. So with apologies to the youngsters in the audience, I propose to name it after a piece of work carried out by some gurus of the 1970s. No, not Milton Friedman nor Black and Scholes, but the Eagles. For this is 'Hotel California' risk. It refers to being in a position where, in the words of the song, 'you can check out any time you like - But you can never leave'.

After all that, I'd like to say a few words about something a bit less dated - technology. Later today we have two sessions, the second of which discusses the new multibank platforms, and the first, in a few minutes, Internet trading. Such platforms provide an opportunity for banks to cut costs, and deliver value-added transactions, either because the sales force is freed up from what they might call 'bog standard' queries, or because the electronic processing of deal information allows more intelligent solutions to be provided for a client's problems. But this pressure to cut costs will make banks look much more carefully at each of the services they provide, and the charges they make for them. And that brings me to the final part of my talk.

May I leave you with some awkward questions?

Will greater transparency result from the new technology? If so, will it spotlight the importance of credit in foreign exchange? In particular, will banks be prepared to explain straightforwardly to clients how far the spreads they charge reflect the costs of the service, how far a profit margin, and how far a charge for credit and liquidity risks?

Will banks be prepared to continue to provide research and advice for free? If not, will clients be prepared to pay for it explicitly?

How far are banks prepared to subcontract their risk taking services to others? We are increasingly seeing small banks using others as a pricing platform from which to quote to clients.

And how far will users feel change is necessary? Unless banks can use the new technology to cut costs, and pass these savings on to their customers, or use it to provide more tailored solutions to their customers' problems, they cannot expect end-users to change their ways.

I have no doubt that the essentials remain in place for foreign exchange to thrive in the 21st century. But it will need to continue to concentrate on the basics - the provisions of a service, at a competitive price, to those who use it; by the same token end-users will need to remember that services have to be paid for. Technology will not transform the essence of the business. But it may shine a spotlight on some areas in which inefficiencies remain, and on others where cross-subsidisation persists. Twenty years ago, many airlines employed their own catering and cleaning services; now these are subcontracted out to others. One of the challenges for fx in the 21st century will be to see how far it will follow this model, and how far the current integration of the advisory, execution and research services offered by banks will continue.

With those thoughts I shall leave the rest of the day in the capable hands of our five roundtable organisers - Citigroup, Deutsche Bank, UBS Warburg, State Street, and JP Morgan Chase.