

## CHAPTER 12

After a generation of revolutionary change in the global foreign exchange market, the question arises, where does that market go from here? What changes can we expect in the future? In some areas, we can point to emerging trends and possible directions.

## 1. GLOBAL FINANCIAL TRENDS

There is little evidence that the evolution of the world economy toward *deregulation and global integration* is ending, and little reason to expect that the powerful forces that are moving us in those directions will stop suddenly. International trade continues to grow robustly, and international financial transactions and investment far more so. In the United States and many other countries, managed funds are still very heavily invested in domestic assets, which suggests that there is plenty of room for further shifts abroad. Even modest increases in the tendency to look across borders, toward other countries and other currencies for investment opportunities, can have significant implications for levels of activity in the foreign exchange market.

#### ► Introduction of the Euro

In Europe, the move to a single currency—the *euro*—for participating European Community members is expected to reduce global foreign exchange trading below what it would otherwise be. Indeed, the savings from not having to convert from one member country's currency to another are one of the advantages, or efficiencies, expected from the move to a single currency.

It is very difficult to predict just how much the introduction of the euro will affect the level of foreign exchange turnover. More than half of global foreign exchange trading takes place in EC member countries, but that includes a large amount of currency trading that does not reflect

intra-EC transactions. More than half of EC currency trading (or 36 percent of global currency trading) represents foreign exchange trading in the huge international market in London, which transacts foreign exchange business of nations all around the world.

Even so, the move to a single currency could significantly reduce the trend of global turnover in foreign exchange trading. While any estimates can be only approximate, it has been estimated that 10 percent of the global foreign exchange market could disappear with the advent of the euro. This is not a very large decline, against the background of a global market that has been growing by an estimated 13 percent a year in past six years.

The decline is not likely to be spread evenly around European financial centers. Questions have been raised about the continued viability as foreign exchange markets of some of the smaller European trading centers that may feel the brunt of the impact of the move to the euro. There are predictions that Europe's (reduced) levels of currency trading will encourage consolidation into a more limited number of centers.

The euro began having profound effects in currency trading several years before its 1999 introduction date. Market exchange rates for those currencies regarded as almost certain to be among the initial euro participants hardly

budgeted against each other. Beginning in the mid-'90s, those currencies performed as though they were already in a virtually fixed relationship with each other. The trading process among these currencies became cut and dried—not very difficult to carry out, and not very profitable. In those circumstances, advice from market professionals becomes less important and less needed, and market players are less willing to pay for it. Corporations began to do more of their buying and selling on their own. Banks and other dealer institutions cut back considerably on the number of traders—in particular, experienced traders—dealing those currencies.

The introduction of the euro may have other effects quite apart from the impact on overall market turnover. Market observers are considering, among other questions, the euro's possible effects on investment portfolios and on central bank reserve holdings, and its possible use as a vehicle currency and a currency anchor. At present, the dollar's role in the global foreign exchange market and financial system is much larger, relatively speaking, than the U.S. economy's share of world production and trade. (The U.S. accounts for about one-fourth of world production and about one-fifth of international trade, but nearly three-fifths of currency reserves, and the U.S. dollar is one of the two currencies involved in more than four-fifths of foreign exchange transactions). The questions are whether—and if so, in what ways—the euro might assume a major role, and what the implications of any such move would be. To what extent will the euro assume, or share with the dollar, the roles of reserve currency, transactions currency, and investment currency? Will other nations around the world feel more concerned about their rate relationship with the euro than with

the dollar, and shift their intervention focus and their reserves accordingly? Will there be an immediate attraction to the euro, or will the result be, as some market observers expect, official reserves shifting out of EC currencies and into dollars in the near-term, because of the initial uncertainties, then shifting out of dollars and into euros in the longer term as the euro gains in credibility and wider use? It is difficult to forecast these events over an extended period.

If all EC members were to shift to the euro, that would represent an economic group somewhat larger in production and in trade than the United States. Certainly, in that event, it would not be surprising if there were a strong international interest in holding and using the euro, given the economic base and the magnitude of the financial forces behind the new currency, and the interest of others in trade, exchange rate, investment, and other relationships with the EC. But there are many uncertainties, many decisions not yet made, and many events that have not yet occurred that will affect the outcome.

#### ► Increased Trading in Currencies of Emerging Market Countries

There are estimates that the introduction of the euro may result in a level of global foreign exchange transactions about 10 percent lower than otherwise. However, increasing foreign exchange market activity with respect to some of the *emerging market economies* and *transitional economies* may offset some of the euro's expected dampening impact on turnover. A number of countries in Asia, Eastern Europe, Latin America, and other parts of the world have been growing, opening up their economies, and shifting toward a more international orientation. Their currencies, which are often more volatile and less liquid,

and trade with wider spreads than those of the major industrial nations, are playing a more important role in global finance and commerce—and are increasingly traded in exchange markets. Although major problems in Asia and elsewhere have severely affected

markets there, many of the emerging markets seem to hold promise of becoming, over time, much more active markets in currency trading. This growth will offset part of the intra-European trading activity that may disappear with the introduction of the euro.

## 2. SHIFTING STRUCTURE OF THE FOREIGN EXCHANGE MARKET

### ► Consolidation and Concentration

After a generation of enormous expansion and integration into a single market, it is reasonable to expect some consolidation and change in the institutional structure of the market.

There is much evidence of consolidation in banking and finance, both in the United States and elsewhere. In the foreign exchange market, with mergers and other forms of restructuring, the number of banks and other firms operating as major dealers and market makers has declined. The number of reporting dealer institutions included in the Federal Reserve surveys declined from 148 to 93 between 1992 and 1998.

Another aspect of consolidation is reflected in the steps taken by many major players to cut back on the number of their outlets, the number of financial centers around the world where they actively trade foreign exchange. The business of trading currencies is highly competitive and pressures are particularly severe during periods of less volatile rates and less rapid growth in turnover. With pressure on profit margins, and with expanding technology increasing the costs of outfitting and operating trading rooms, institutions search for ways to improve efficiency. They look for ways to operate in fewer centers—with fewer traders, fewer trading desks, and less of the expensive equipment that trading desks require—without losing business. With improved

technology and strong emphasis on marketing, some feel that they can service their customers and meet their own proprietary trading needs more efficiently and more competitively with fewer outlets. Some are consolidating to the extent that they limit themselves to a single trading center in each of the three major time zones, while others take different approaches. The tendency toward market concentration has been evident in smaller markets, which some non-local banks have been abandoning, and also in the largest centers. We have seen some increase in the market share of the largest dealers in a number of major centers. In both the U.S. and U.K. markets, the ten largest institutions account for half of total transactions. Whether a trend toward concentration will continue will be influenced by many factors, including technology—for example, the prospects for increased use of the internet in foreign exchange trading, and further development of automated order-matching.

### ► Automated Order-Matching Systems

As technology continues to progress, it doubtlessly will further transform the foreign exchange trading process, and lead to new concepts and new technology. Of great interest is the advance of electronic brokerage systems—computer facilities that match orders among participating dealer institutions around the world. These systems (as noted in Chapter 7) have had a major and growing impact since their introduction in 1992. The share of total

foreign exchange trading handled by electronic brokering is 13 percent of total turnover in the United States, and 11 percent in London, and it continues to grow. More significant is the much larger and rapidly growing share of turnover in those segments of the market where electronic brokering is most popular—that is, spot transactions in a limited number of high volume currency pairs (such as dollar-mark) where there is much liquidity and a heavy flow of trading activity. In such markets, automated order-matching systems can offer very tight spreads of one or two basis points, or about one-third of previous spreads.

The two electronic brokers presently operating (Reuters and Electronic Broking Service, or EBS) have gained an important market share, and have attracted business from voice brokers and also from banks dealing directly with each other by telephone and other

channels. Brokers and others adversely affected by this development are, understandably, seeking to respond by improving their own practices, broadening the services they provide, and making their operations more efficient.

Electronic brokering initially concentrated on the spot market for the most popular currency pairs, but it is moving into other segments of the market. There are now some transactions in the forward market, and interest rate products are being developed. It is expected that in the future more market participants will be arranging their foreign exchange transactions directly with counterparties, rather than feeding the transactions up through major dealers and voice brokers. Looking ahead, certainly the further development of electronic broking could have important implications for future market liquidity and mode of operation.

### 3. NEW INSTRUMENTS, NEW SYSTEMS

The development of derivative instruments continues. Non-deliverable forwards and options are being used in some emerging markets. Building on that concept, some market participants see a significant future role for “foreign exchange, difference settled” (FXDS) more broadly. The instrument would be used for key currencies and for spot as well as forward trades, for transactions where the counterparties do not want delivery of the underlying currencies, and arrange to settle by paying or receiving only the difference between their contract price and a benchmark exchange rate. However, various operational issues—and, in the United States, also regulatory issues—remain to be resolved.

One effect of FXDS would be a reduction in settlements and settlement risks. This might complement the effort initiated by a consortium of international banks to create a bank, CLS bank, which would carry out continuous linked settlements of foreign exchange transactions, so that one bank’s money would be paid over only simultaneously with its counterparty’s payment.

To conclude, looking to the future, to a large extent, the shape and direction of the foreign exchange market will depend, not only on these technical issues, but also on how nations and governments of the world manage their affairs. Can we look to a period of good economic policy

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and progress, with markets reasonably stable and effective, or will there be large-scale disruptions and volatility of the kind we have experienced at times in the past? The

foreign exchange market will adapt to the circumstances within which it is obliged to operate and respond to changing conditions in the world economy and financial environment.

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