

## The foreign-exchange market

## Fixed rates

## The money-spinners await their fate

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A CITY worker looking for a quiet place to nap nowadays could do worse than head for his bank's foreign-exchange (FX) trading floor. Once noisy with activity as gesticulating dealers moved around billions of dollars, euros and yen, it is more likely now to be an oasis of calm. Bankers are plain bored. "The FX market has been exceptionally quiet," moaned currency analysts at Citigroup recently. "In fact, it's been so quiet that there was almost no point in writing this report."

The summertime torpor disguises existential angst. Regulators across the world are probing the role of banks in currency trading, apparently convinced it is the latest financial market to have been fiddled. Around 30 bank staff, including many trading-floor bosses, have been suspended or fired. Hefty fines seem inevitable. Worse, reforms may tear the heart out of the FX market as it is presently constituted. Banks, which make money by offering to buy or sell currencies from or to their clients, could go from being central actors to bit players. The future of a business which used to reap annual revenues of \$20 billion is at stake.

Not that such bounty is attainable these days anyway, given the placid state of the market. Currency-trading volumes have slumped. That is largely because the world's big central banks have replaced yo-yo-ing interest rates—which in turn determine the levels of their currency—with a uniform near-zero level since the financial crisis (see chart 1). The upshot is that floating exchange rates have seldom been so stable: volatility has plunged to its lowest level in two decades (see chart 2).

As a result, once-keen users of banks' FX services have learned to do without them. Multinationals that might once have tried to hedge their foreign-currency exposures now opt to live with the risk, assuming that exchange-rate movements will remain within a limited range. Financial firms, which make up over 90% of trading volumes, have also pared back. Hedge funds that wager on currencies have shrunk or left the market in recent years. And banks, whose traders sometimes also bet on market moves, are no longer keen to do so. Appetite for risk is non-existent: "This is not a time to try something clever in FX," says a trading boss in London.

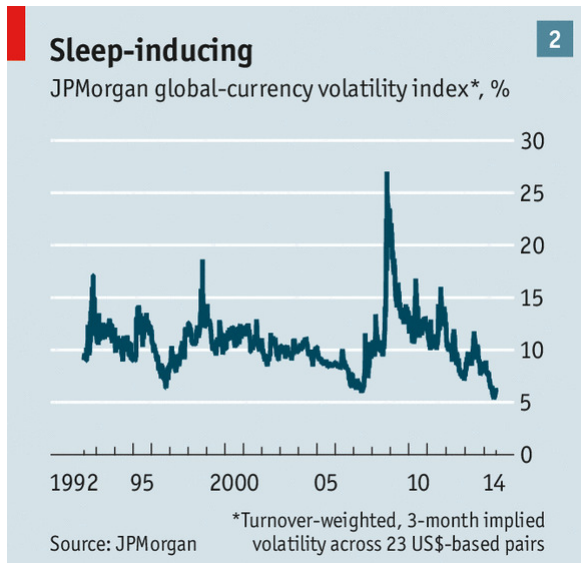
Volatility will eventually come back—British holidaygoers may have noticed the value of the pound rising and falling this week—as the world's biggest economies recover and interest rates move around more. But the tidy profits once made by banks may not. Much of the market for major currency pairs, such as dollar-euro or pound-yen, is now conducted electronically. Anyone wanting to exchange less than \$100m is unlikely even to speak to a human being these days. The spreads on trades (the difference between the price at which banks buy and sell currencies) have become vanishingly thin. Even the profits to be made on making markets in more obscure emerging-market currencies, where spreads were once wider, have evaporated. High-frequency traders are moving in, too, hobbling banks.

But the big worry is what regulators are likely to say and do. Although they have yet to detail their case against banks, their investigations are focusing on whether FX traders bilked clients by fiddling widely-used daily benchmarks. There is nothing sophisticated about the alleged fraud: clients looking to buy or sell FX from bank trading desks agreed to price currency deals at the price prevailing at 4pm London time, regardless of when the order was placed. Bankers soon found they could bend that price in their favour, and they did. Worse, they appear to have colluded in order to execute the scam. The transcripts of online chat rooms they used, dubbed "the Cartel" and "the Bandits' Club", are likely to amuse neither bank compliance officers nor regulators.

Much of the errant behaviour happened after banks promised to clean up, having been caught tampering with LIBOR, an interest rate used to peg contracts worth trillions of dollars. Their most plausible defence is that some watchdogs knew about the way the market actually worked, including the collusion. The Bank of England, which oversees the world's biggest FX centre in London, has suspended an employee.

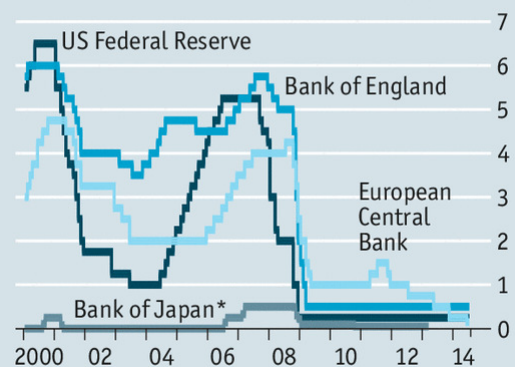
The fines for the currency fiddle could reach \$26 billion globally, according to KBW, a bank. Cheated clients might sue for compensation, too. Many complain the market is no longer fit for purpose. The more powerful among them, including giant institutional investors and asset managers, might egg on regulators who want to change the way currencies are traded. The Financial Stability Board, a committee of global supervisors, has floated the idea of a "global utility" that would match supply and demand of currencies. Whatever that means—and few know for sure—it sounds like a way of sidelining bankers. More details are expected in time for a meeting of G20 leaders in November.

Banks think a "fine-tuning" of the FX market and a stern reminder to traders not to be crooked would suffice. Some are paring back their currency activities, worried about profits being squashed between fixed costs and shrinking revenues—down to \$13 billion this year, thinks Morgan Stanley, a bank. Those that remain may find it a harder environment to thrive in.



## No more yo-yo

### Policy interest rates, %



Source: Haver Analytics

\*Japan changed to a monetary-base target in April 2013