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The attraction of Foreign Exchange and the role of ACI The Financial Markets Association

The financial markets are highlighted these days with many headlines: the '*Petro Dollar phenomenon*' , or '*US-dollar – quo vadis (?)*', or '*Sub Prime – financial turmoil in US and Europe*', or '*BIS confirms sharp increase in the daily traded FX volume*' or '*Monetary Reserves – the Asian strength*' …..

At all, talking about Foreign Exchange is talking about superlatives in the Financial Markets - and of course I am very proud for being charged to represent these traders on behalf of our international traders association. In this column I will spot on the mystery of FOREX (FX or Foreign Exchange Markets) but also introduce you to the role of ACI The Financial Markets Association - the former FOREX Club.

First off and without any doubt the Foreign Exchange business is doing great. In their last triennial survey the BIS (Bank for International Settlement) just recently confirmed the sharp increase of the FX market to $ 3,2 trillion in the over-the-counter activities in the year to April 2007 showing an increase of 71% in comparison to 2004. Wow – what is driving these markets so strong? What is the business behind and who are these traders, hedgers or investors?

FX as a trading tool but also newly discovered by investors

Many elements are linked to FX: largest over-the-counter market in the world, open 24 hours a day (5-6 days a week), global market, mainly unregulated, easy market access, deep market liquidity, high leverage possibilities, simplicity in handling, narrow prices, interbank or exchange trading, margin trading, but also electronic and algorithmic trading, prime brokerage, no or low commission/fees, technical market trading, intraday trading, volatility ….. - At the very first moment FX looks rather complex. And indeed FX trading demands for discipline, experience and concentration.

By its nature of being a volatile trading vehicle FX is not only in the daily press focus but it became also discovered by various market participants/investors. Furthermore during the past period of low interest rates many new investors entered into the FX markets aiming to enhance their performance. The achieved results were encouraging and the market has grown with them. Not only market professionals but also retail customers recognized the FX market during the past years and the vendors and banks industry jumped on the train providing the most diverse platforms for trading to potential customers.

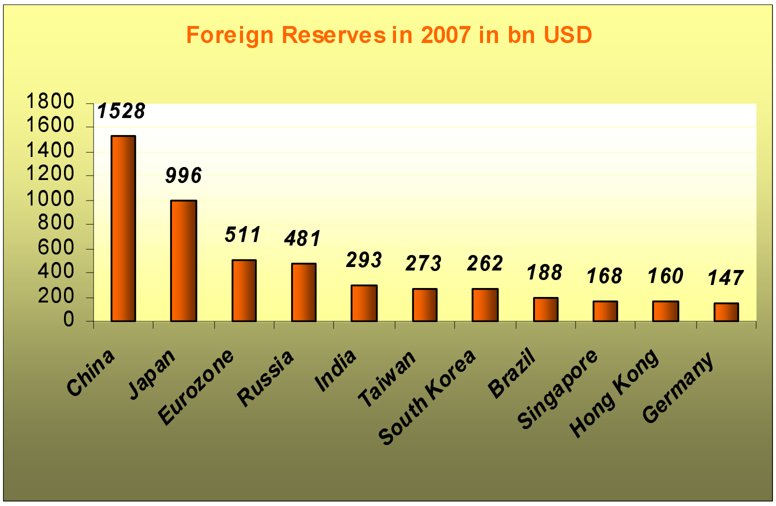
I am tempted to say that market participants or entrants realized foreign exchange as a reliable and even better predictable instrument than e.g. the equity markets (of course depending on economic stage of a cycle). For instance, during the past couple of months we have seen many examples when stock markets crashed by e.g. 30% or even more within very short time. On the other hand it will be hardly imaginable that e.g. the EUR will collapse in the FX markets from 1,50 against the $ to 1,05 within one or a few days! But take care sometimes we are realizing similar movements in emerging markets but they stay the exclusion and will be treated in different manner by risk management when traded. So whilst stock markets (even blue chips) might crash overnight we mainly will see such developments of larger appreciations/depreciations in the FX markets over longer periods. Exceptions in FX are always possible!

Not for being misunderstood, FX trading is and will stay a challenge for traders and other investors. Traders do have to keep up markets' liquidity and they do need to react immediately on political or economical statements and developments. Different types of traders are watching and following the daily or periodical movements. We might classify them into the tick traders (scalper), the day traders, swing traders and position traders. Some of them are looking only for a few ticks during a day whilst others are checking the fundamentals or doing technical analysis in the markets for their trading decisions. Every one of them behaves different in the markets! Investors are mainly seeking for carry trades – borrowing a low-yield currency and investing in a high-yielding one. Their decisions are mainly influenced on the outlook of currency volatility. In principle markets provide excellent liquidity and the spreads are mostly very narrow.

Foreign Exchange Reserves and traded volumes

The FX markets are influenced by many factors. Traders or others are taking their positions (providing liquidity to the markets!) but also fulfilling the daily orders. Some of them are enormous sized so that their execution often moves the markets – at least for a shorter period. On the other hand economic or political developments are directly influencing the markets. Every day the whole industry looks after the release of figures (economic indicators) – they will have immediate consequences to the market. They same happens when political developments or even terrorist attacks might surprise our globe.

But we also should not forget other long term driving factors of FX. We have to realize the world changed a lot. Whilst the Bundesbank played a mighty role in previous days (due to their power on FX interventions in the markets when necessary), now and cause of their size some market participants became nearly the same powerful. Specifically in emerging markets they will have the power to move but also largely influence them. What do we know on the relocation of foreign currency reserves held worldwide? Whilst approximately still 65% of the reserves are held in USD just some 25% are kept in EUR. Some countries announced, they will more diversify their reserves in the future. So it will be easy to predict, that reserves held in EUR will grow faster than those in USD. There still remains the risk of active shifting from USD into EUR or other currencies. Once so happening, we might face that the currency structure might get confused.



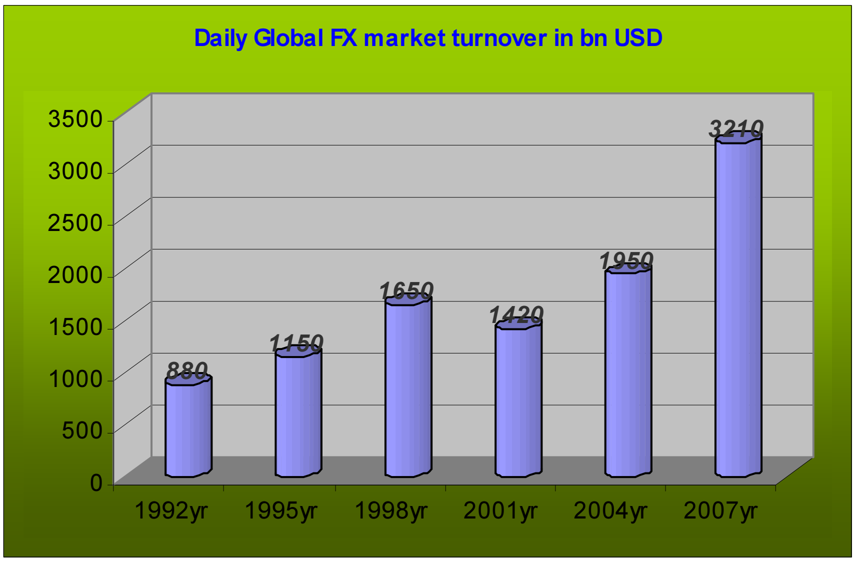
Source: Wikipedia

An interesting view (but too far leading here) of an adequate level of foreign exchange reserves would be: '*How much is enough*?' - as Foreign Currency Reserves count as a last resort stock of FX for the financing of foreign currency outflows. But reserves further do help to maintain the confidence in the currency of a country.

Whilst on one hand the reserves in particularly some countries are strong rising the daily trading volumes in the FX markets moved up too (by 71% from 4/2004 – 4/2007). The following factors most probably have accounted for this development:

- expansion in the activity of investor groups (including hedge funds)
- expansion of retail investors
- a trend from institutional investors with a longer-term investment horizon
- "electronic trading" (in particular 'algorithmic trading')

Growth was reported by the BIS survey across the entire all instruments but it was particularly impressive in the FX swap markets. Here I had like to stress that the U.K. and the U.S. are still the world's largest Foreign Exchange Markets.



Source: BIS

The Role of ACI – The Financial Markets Association

ACI – The Financial Markets Association represents the interests of their members, working within a financial institution or a financial services provider. Their members are, in large part, engaged within the financial trading or sales environment in the global financial markets. The financial of markets per definition incorporates Foreign Exchange, Interest Rate Products and other Securities, Banknotes & Bullions, Precious metals and Commodities and their various kinds of Derivatives.

ACI provides a standard to the International Financial Markets in terms of

- maintaining a *professional level* of competence and ethical standards,
- market *liquidity provided* by their traders,
- giving advice and *offering arbitration* services in professional disagreements or disputes,
- offering a global *third party certification* (ACI Dealing Certificate, ACI Operations Certificate, ACI Diploma,
- personal and company *networking*.

Besides Regulators, Central Banks and other authorities the role of ACI is to "fine tune" the traders community, to recognize their needs and to represent their demands. Coming back to the daily headlines in the financial markets they are just underlying the importance of an Association like ours.

Electronic Trading has largely influenced our trader's behaviour. One of my goals will be to enhance the personal contacts of the traders again. 'Know your members' or 'Know your partners' will be one of my keywords for the next time. Besides education the networking is one of the keys for personal but also for company success.

White labelling of our business or the most different trading possibilities are challenging our industry. May we recommend to trade for instance via any kind of a 'messenger'? How to behave on 'off premises trading'? etc. ACI's Committee for Professionalism formulates and proposes guidelines, both technical and ethical, concerning the operations of the markets and the professional activities of ACI members. These guidelines comprise 'The Model Code'. This Code is designed to have global application in the OTC professional financial products market.

Our Financial Markets are largely influenced or determined by economic and political incidents. However shocks are arising, it will be always the trader's fate on the front to resist, to keep up market's liquidity and to protect the positions. On the other hand, to enable efficient and smooth operations in the trading rooms ACI's tasks lies:

- in a globally acknowledged portable professional qualification of traders (via certification)
- in supporting a fair playground in our mostly unregulated markets

and finally

- being the academic conscience in the industry in times of market imbalances.