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# Volatility returns to the FX markets

Friday, March 7th 2008, just when writing these lines the Euro hit a record high against the Dollar at 1,5459 after the release of the U.S. non-farm payrolls. The effective rate surprised the market consensus and turned out to be a drop for the second straight month. There is a lot of concern about how the huge downturn in the U.S. economy is going to affect the rest of the world. Politics and economic outlook nurture the financial markets with uncertainty which results in continuing high volatility at the end.

Let me assume that volatility is not what Central Banks are looking for. It will be rather the opposite: Central Banks

have a strong interest in a smooth functioning of their economies. Just recently the Eurogroup Chairman Jean-Claude Juncker criticized the Euro's sharp gain and stated clearly 'we don't like excess volatility in the foreign exchange rate'. But to stay realistic: in a complex and changing world in the sense of no or only little overall volatility in the economy this may not be achievable. I also would like to stress and remember that monetary policy may have strong implications for markets' volatility. Considering the substantial differences in the structures of the various national economies and in the interests of governments the exchange rate as and adjustment tool, amongst others, is still of high efficiency.

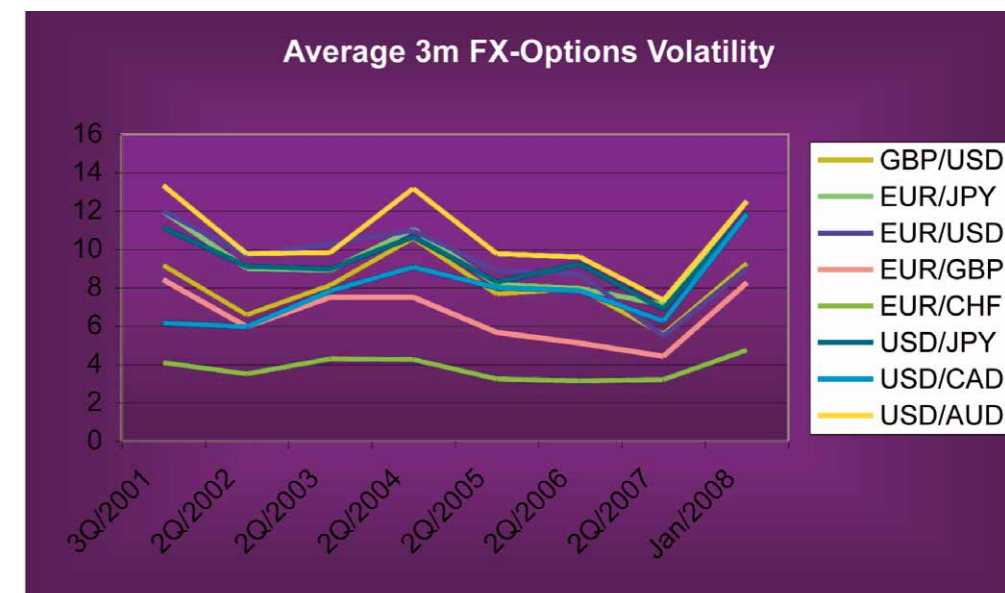
Traders are providing the liquidity needed to the markets after analyzing and reacting on political

or economical statements or developments. The enormous daily volume of OTC or e-Traded Foreign Exchange products keep prices low. The spreads narrowed to a minimum and in particular e-Trading brought further transparency to the markets. Certainly volatility comes at cost, and from time to time, a transactions tax – the so called Tobin tax – is argued to reduce volatility by discouraging speculative trading. I am seriously against such ideas as they are absolutely misleading and disregarding the real factors influencing the financial markets. But such a tax will further raise transaction costs for customers.

Again, traders, customers, hedgers etc. are following the given market environment. January 4th 1999, the market implementation of the EUR, the opening market price in

Sydney was at 1,1747 Dollars. The market even moved to nearly 1,19 in the coming months before it slipped to its low in October 2000 at 0,8225. It was the uncertainty of politics and economy which caused the depreciation of the EUR of nearly 30%. There was the Balkan war, the markets just passed the East Asian crisis, the Russian crisis and the Brazil crisis and the newly implemented EUR provided less fantasy and was not yet market proved. Well, it was an easy game for the Dollar. The world again changed with the Tech Stock worries in 2000 but in particular with 9/11. The following years not only reduced the interest rate environment but also lead to historical lows in the foreign exchange volatility, which was seen between 4th quarter 2006 and 2nd quarter 2007.

The low volatility in interest rates but also in stock markets in the years after 9/11 encouraged other institutional investors seeking an alternative asset classes. Foreign Exchange was then discovered by them and turned out to provide comparable returns – due to good intraday volatility of FX and many tradable currency pairs the returns were quiet often better than those of bonds and equities. In one of my last columns I was interpreting the last BIS survey which confirms this development of increasing FX volume.



Carry traders themselves used the low FX volatility environment for their positioning. Borrowing a low-yield currency and investing in a high-yielding one was the game. Traders of course like volatility. Usually the traded volumes increase by raising volatility and vice versa. The phenomenon of carry trading investments was that a low provided volatility environment led to increased turnover in the markets. Investors created extreme positions not only staying in developed currencies but also moving into emerging markets.

Now it seems, these days are gone for the time being. The acute economic uncertainty raised volatility in FX (and other markets too). Sub-Prime suddenly changed the picture by mid last year. The US is probably going into a recession and as in the decades before the current strength of the EUR, the JPY and in particular the CHF is recognized again as a currency of safe haven. Carry trading is not decisive any more.

Huge portfolios were turned to optimize the return but also to reduce the risk of currency movements. The daily volatility in currencies jumped and some emerging currencies see up to 5% or even higher of daily fluctuations.

The current situation mirrors the balancing of our financial markets by themselves. In years past we have seen historical lows in FX volatilities but also on interest rate levels. The current liquidity crisis may turn out to be bigger than assumed (latest surveys are talking of USD 600 billion) and is far away from a transparent situation. The current increase of volatility in the FX market is the result of uncertain and obscure economical developments.

The FX market does not need any regulation but regulators are encouraged to provide a fair and transparent playground and to watch very carefully the innovative developments in other areas of the financial markets or in the banking industry.