

2008 trends: Reduced growth set to fuel FX competition

As the market gears up for a fresh year of activity, Patrick Lefler, FX consultant at Wall Street Systems, identifies last year's defining trends and predicts the key FX market developments for 2008.

As another new year begins, the big question on everyone's mind is where the FX market is headed in 2008. Over the past 12 months, the market has been characterised by rapid growth in the Asian markets, a continued dollar weakness, and an increasing maturity in e-FX trading platforms. Additionally, the sub-prime crisis has begun to have a powerful impact on the market with regards to risk management and credit. So what lies ahead in 2008? While few are prepared to stake their reputation on guessing future developments with regards to market direction and volatility, a couple of factors stand out which offer valuable clues with regards to growth prospects for the coming months.

Asian growth continues

One area that saw tremendous growth in 2007 and looks likely to continue this trend in 2008 is Asia – particularly China. With the 2008 Olympics taking place in Beijing next year, China is under obvious pressure, even from within, to be more “democratic” than ever. As a result, there is likely to be an increased willingness to ‘float’ Chinese currency. It is unlikely that the yuan will be fully floated, but it will definitely become more valuable against the US dollar than it is now. This activity will have a positive knock-on effect for China's economy if the country succeeds in hosting a successful, well-organised, cultural event. The expansion of other non-traditional markets, including Eastern Europe, Latin America and other Asian territories also looks set to continue and this will help to maintain market growth overall.

Feeling the crunch

The continuing subprime crisis will affect the market in a number of different ways. Banks are becoming increasingly concerned with risk management issues. As a result, they are likely to concentrate their energies on risk management rather than improving their trade processing and trade volume capabilities. This priority change would affect everything from the funding of IT projects to the different ways that risk is measured and allocated. Risk levels would most likely be reduced throughout the market as a result. This would also translate directly into banks and prime brokerages reducing the amount of credit extended in 2008. While this would affect all areas of the market, its effect on the issuance and hedging of credit default obligations (CDO) and credit default swaps (CDS) would be significant. With much of the FX market growth over the past few years coming from the hedging of these instruments, any reduction in their issuance would have a negative effect on FX market growth in 2008.

The credit contraction will also have a marked effect on the balance sheets of leveraged players who have also contributed to FX market growth over the past few years. As credit levels are reduced, highly leveraged institutions such as hedge funds will most likely have less capital to trade with. This will force them to reduce

their balance sheet, take fewer positions and carry out fewer FX trades – depriving the market of an aggressive source of growth.

With the subprime crisis far from over, there is growing uncertainty within the financial markets. As write-downs continue, banks are looking for additional sources of capital. Some of this will be satisfied from Asian sources and the rest may come from mergers and consolidations. If the crisis continues for the better part of 2008, this could have negative consequences for the FX market in terms of overall growth. In a worse-case scenario, 2008 could be characterised by flat to negative growth within the FX market.

Looking ahead

It is difficult to say exactly how the market will develop over the coming months. As always, market direction and volatility remain impossible to predict. The 2008 market may prove to be less stable than in the past as a result of the ongoing subprime crisis. If the crisis remains unchecked during the next few months, we may see other areas of the market that could come under pressure (CDO, CDS). The one thing that will remain constant is the need for banks to remain just as competitive as in previous years. The relative slowing down of the market does not mean that banks themselves can slow down. Margin declines will also continue and this will help fuel fierce competition. The one thing for certain is that banks will be under constant pressure to find ways of balancing the need to deal with expansion alongside their risk management and margin enhancement agendas.

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