Annual Dinner of the Bank of England Foreign Exchange Joint Standing Committee

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- It is sobering to think that for ten of the last 15 years at least one major region of the world has been in some sort of economic crisis.

- From the LatAm defaults and the Asian financial crisis in the 1990s, to the dot-com crash and the Global Credit Crisis in the 2000s, these events have shaped the age we live in – and none were adequately foreseen.

- The dominant themes of our professional lives are turning out to be change and uncertainty.

- For leaders now – whether new leaders in China, a second-term President in the US, the heads of the eurozone economies, or leaders in business – the primary challenge has become managing complexity in the face of this uncertainty.

- This is also true in foreign exchange as the market evolves. And, as a former FX trader, I've watched these changes with interest.

- Over the longer term the industry has seen huge shifts such as the rise of computer based algo trading and a transformation in volumes, with an eightfold increase between 1989 and 2010.

- But it seems a new and significant shift is taking place now:
  - Volatility has hit its lowest levels in five years.
  - Volumes have fallen across the market.
  - There is simply less opportunity to make money.

- This is the continuation of a trend which has accelerated since the crisis broke in 2008, defined by:
  - Increased competition.
  - Increased price transparency.
  - Increased regulation.
  - All leading to spread compression – which we have seen to a significant degree in the last 6 months.

- Moreover, it seems that the rules have changed:
  - The usual drivers, such as interest rate differentials and economic growth, have been replaced with politics or perhaps it's better to say governments.
  - Where once the industry could rely more on concrete facts, now it is ruled by perception, and therefore by ambiguity.
  - While the carry trade used to be the dominant force, now it is the phenomenon of risk-on / risk-off. At times itself a somewhat circular ex-post explanation for hard to explain price action and unusually correlated asset classes.

- The political calendar is dictating the agenda. Trading was quieter than usual over the summer as investors waited for central bankers to give markets some direction.

- Central banks have taken on a new role:
  - Unconventional monetary easing policies have become a key element of the risk-on / risk-off dynamic.
  - Before the Fed and the Bank of England embarked on QE, the market expectation was that it would be currency negative.
  - But QE has been ambiguous in its impact.

- And the Fed's monetary easing in September did not spark a clear move in the FX market:
  - Some had expected the dollar to weaken and risk appetite to soar.
  - But it didn't happen because of concerns about weak global economic growth.
  - That has left major currency pairs such as the euro-dollar still trapped in a range.

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- The next risk – and the most pressing – is the US fiscal cliff:
  - The risk-on mood triggered by the Obama win will be tested as the edge of the cliff comes closer.

- But the trend – if there is such a thing at present – is once again that governments and not so called free market forces will dominate and inform price action in a manner we had forgotten or really not seen much, if at all prior to the 2007-11 crisis.

- Back then asset prices seemed to be set by the collective wisdom of market participants whereas now Governments and central banks are doing all they can:
  - People have underestimated this determination before; shorting the EUR in vain.
  - Only to see actions by Mario Draghi significantly reduce the ultimate tail risk of nations leaving the eurozone by promising to do "whatever it takes" to save the currency and introducing his plan to buy government bonds.
  - In effect central banks across the world have intervened to stabilise or tame the currency markets.

- This activism is clearly having an impact. It is striking that, despite economic conditions, the dollar, euro and sterling have all remained broadly stable. It seems that economic conditions are no longer driven by currency moves.

- In a zero interest-rate policy world coupled with new and different expansionary monetary policies, the transmission mechanism onto currencies is ambiguous.

- This lack of clarity creates a confused picture. Many hanker after the days when carry was the only game in town.

- And as the market is evolving so the industry is adapting to it:
  - As capturing revenue from a pure spread point of view becomes more difficult, there is a need for continued investment in IT to improve the efficiency of the business model. Driving down cost per ticket, or by delayering by combining PCM and FX teams.
  - Plus the location of the opportunity is changing. By 2050 the global economy will look completely different. The so-called 'emerging markets' will have emerged – instead of the emerging/developed labels, it will simply be a question of countries growing at different speeds. This means providing clients with greater access to credit and liquidity where it is most needed – which may not be where as banks' operations are focused today.
  - In retail FX, changes in technology are creating new ways of connecting to clients and therefore greater competition, with companies like Facebook and Google entering the market.
  - The point is: the industry must adapt.

- Meanwhile regulatory pressure is still significant in many markets.
  - Although the US Treasury's announcement to exempt FX swaps and forwards from central clearing under Dodd-Frank is a big relief to all of us.

- There is however one certainty, which is that the biggest change in the FX market in the coming years will be the rise of a new global currency in the RMB.

- With China's new leaders taking their roles in the New Year, there is likely to be a renewed emphasis on reform which will support internationalisation of the currency.
  - The new leaders are the first not to be appointed by the revolutionary cadre and should therefore prove more pragmatic and ideologically flexible.
  - They were educated in the 1960s and 1970s, and so, having experienced the Cultural Revolution first hand, are likely to see social stability as a key responsibility.
  - Having witnessed China's economic transformation in the 1980s and 1990s, they are likely to be believers in the market economy.

- We expect to see further interest rate liberalisation in the coming years – especially given the pressing need to deepen capital markets.
  - The recent adjustment to the ceiling for deposit and lending rates by the People's Bank of China is the first step.

- We also expect to see faster development of bond markets and other long-term financing instruments. Domestic bond markets are likely to double in size in the next five years.

- A functioning bond market is a necessary step before making the RMB convertible.

- Clearly the international acceptance of a currency goes hand in hand with a country's economic power – sterling in the nineteenth century, the rise of the dollar in the twentieth, joined latterly by the euro.

- Therefore the internationalisation of the RMB is long overdue and inevitable.

- The process of internationalisation is likely to fall into three stages:

  - Stage 1 is becoming a trading currency. In the first three quarters of this year, 11% of China's international trade was settled in RMB. By 2015, that proportion is likely to rise to 30%. This would be the equivalent of around 2 trillion US dollars – which would make the RMB one of the top three global trade settlement currencies.

  - Stage 2 is becoming an investment currency. Arguably the RMB is in this stage now – and there is clear momentum. In the first half of this year RMB-denominated onshore and offshore corporate investment grade bonds surpassed US dollar-denominated bonds for the first time. The onshore market is already the third largest bond market in the world, and will continue to grow.

  - Stage 3 is becoming, in the long term, a reserve currency. Clearly this is still a long way off. The RMB still lacks many of the required characteristics of a reserve currency – and is starting from a very low base.

- This internationalisation process is being closely supervised by the PBOC.

- But while it will be gradual and controlled, the repercussions for all of us will be huge – and some changes are already happening.

- Here are 8 implications of the RMB's rise:

1. The large Chinese banks will have a much bigger global presence in Non-Asian centres. This is already beginning to happen in London.

2. Central Banks will increase their accumulation of RMB reserves in the form of cash and bonds:
   - Central banks are already doing this in at least 9 countries – including Saudi Arabia, Russia, Korea, Thailand, Nigeria, and Venezuela.
   - It has been reported that Africa's RMB-denominated reserves will reach 20%, or $100bn, in five years.

3. I believe the RMB will become a convertible currency within five years – and, consequently:
   - greater RMB volatility will increase trading volumes…
   - which will help to deepen and expand China's FX market, improving price discovery in the process.

4. The use of RMB for trade settlement and trade finance by international institutions will increase rapidly.
   - The growth potential is in Asia Pacific, Middle East and Africa.
   - At least 50% of China's trade flows with emerging markets will be in RMB by 2015.
   - Europe is already transacting a good volume, which will also grow.

5. There will be greater access to onshore investment by offshore institutions – and visa versa. This will take the form of further increases to QFII, RQFII, QDII, QDLP quotas.

6. In Hong Kong the RMB will begin to overshadow the HKD. As the Hong Kong economy moves towards greater use of RMB there will be no need to change the peg because the amount of HKD currency in circulation will gradually decline. In Hong Kong RMB is being used now in cabs, supermarkets and other retail establishments.

7. Hong Kong will continue to dominate the offshore market:
   - Hong Kong currently accounts for 79% of all cross border RMB trades.
   - The offshore deposit base saw annualised growth of 280% in 2011.
   - As of August 2012, total RMB deposits in Hong Kong stood at RMB552bn, accounting for 8.6% of total deposits in the banking system.
   - HK's RMB bond market is valued at RMB74bn, still a fraction of the RMB834bn that foreign central banks can theoretically tap into through outstanding FX swap contracts.

8. London should seek to assert its position as an offshore centre to complement HK:
   - With 40% of global FX trade, London is already featuring heavily.
   - In 2011 London traded 26% of offshore market in RMB spot FX
   - London's pension funds, insurance companies and hedge funds are thinking about their options in RMB as an investment class.
   - The government is strongly behind establishing London as the Western RMB hub. The City's FX expertise is a key selling point.

- To conclude:
  - The markets are harder to make money from – less volatility; new entrants like Google are reducing spreads.
  - Regulation itself reduces profitability
  - There will be fewer jobs.
  - The catalyst for new growth lies in the East.

- Thank you.