



Forex Visionaries



'The Internet itself will turn into one large exchange' – Richard Olsen

"The global economic system is dysfunctional because of the mis-match between the modern technology used in the real economy and the operational procedures of the financial system."

Richard Olsen is an economic researcher in high frequency finance. He has a long experience and strong knowledge of the forex market structure, technology and buy/sell side. "The financial system needs to be reformed, which is not as difficult as people might think", he stressed.

Olsen proposes the introduction of electronic certificates, global early warning system or stabilising investment strategies, among other innovations. He also gives us his forecast on the market volume and turnover, diversity of market players, investment products, ethic changes or technology and Internet evolutions. "Long-term, there will be one centralised exchange – it will be embedded and integral part of the Internet," he foreshadows.

The BIS survey reports that spot volume is \$1.5 trillion per day in Forex.

FXstreet.com has interviewed a series of "Forex Visionaries" to map out a future for the FX industry. *Profit & Loss* is exclusively serialising the interviews over coming issues, and we start with Richard Olsen.

Are currency markets really as liquid as BIS surveys imply?

No, they are not. To the contrary. The actual spot volume of \$1.5 trillion per day translates into a small transaction volume of only \$17 million per second. On average there is only \$8.5 million buying and \$8.5 million selling volume. If an order of \$100 million is

triggered, then this order will dominate the market for 10 seconds and more. So relatively small market orders of \$100 million or even less can trigger powerful price moves, which can bring about margin calls that amplify the imbalance of buyers and sellers pushing the price even further.

Will transactions turnover increase or decrease in the future?

In the very long-term volumes in the foreign exchange markets will increase massively with the success of quantitative trading strategies that gain wider acceptance. Short-term, I expect volumes to decline, because of the increased uncertainty due to the economic crisis.

In this economic crisis context, some central banks decide to inject money in the market. What effect do these interventions have on the functioning of markets?

The recent interventions of the SNB and BOJ stabilise markets in the short-term, but increase volatility in the long-term. The interventions of the central banks skew the perceptions of market participants. Market participants rely on central banks to continue to intervene;

this skews the balance of buyers and sellers. As SNB and BOJ continue to intervene, more and more traders go short, CHF and JPY. When ultimately the price level breaks, the selling volume of margin calls is far larger than would have been the case otherwise increasing the size of the adverse price movement.

Will the market maker's model be modified in the future?

In recent years, we have observed that the Internet is rapidly mutating from a pure information network into a global market place. I expect that this development will accelerate and that the Internet itself will turn into one large exchange.

My long-term expectation is that traders will trade electronic certificates, a virtual representation of the underlying financial asset, directly on the Internet exchange. We are not yet there, but this is the major development that will take place.

In one respect the Internet exchange will function differently to other organised exchanges: the ranking of bid/ask limit orders will be done on the basis of the size of the respective spread, not the best bid or ask. This change is important, because the direct access with a ranking system based on best bid/ask gives rise to a price instability, which high frequency traders take advantage of.

Do you expect diversity in the types of market players (besides liquidity players, commercial and speculators) to increase in the future?

Yes. In the recent past, we have observed a rapid increase of the number of retail traders; only 10 years ago, this group was quasi non-existent. Today, retail traders account for up to 10% of global volume. Corporations do hardly any foreign exchange trading, only the absolute minimum, this will change, when they become aware of the true cost



of their passive strategy and the benefits of dynamic hedging. Going forward there will be a lot of growth in volume and diversity of market participants.

What kind of trading strategy should be developed based on this scenario of volume and market participants increase?

Our trading algorithms take advantage of the diversity of trader profiles: our models measure the degree of imbalance between the different groups and identify trading opportunities, when the groups get out of line with each other and there is a large disequilibrium. We take advantage of the disequilibrium to take counter-trend positions i.e. we push back when markets overreact. In doing so, we contribute to market stability. We take advantage of the ongoing up and down move of the market to gradually improve the price average of our positions and then close out the position, when we have reached our profit objective.

What is your assessment of today's financial system structure?

My assessment might sound too negative; the global financial system has gone beyond the point of no return. The sovereign debt crisis, which has inflicted Iceland, Ireland, Greece and Italy will spread to other countries, not just at the outer frontiers of globalisation. The crisis cannot be averted. Refinancing rates will go through the roof, Central banks are highly leveraged and do not have the necessary firing power to avert the real crisis, when the global economy starts to slow in earnest and investors panic. There will be a meltdown.

The global economic system is dysfunctional because of the mismatch between the modern technology used in the real economy and the operational procedures of the financial system, where there is no ongoing settlement and the whole system is batch based. The financial system needs to be reformed, which is not as difficult as people might think.

Your view of the current system is negative, but there is still hope then...

There is not just one thing that needs to be done to make the world safer and

more robust. Reforms at several different levels are necessary. If we go for partial solutions, then things can even get worse.

What reforms would make the financial structure works better and more safely?

We need to embrace new ideas. We have to streamline the back office operations and move to instantaneous settlement with second by second interest rate payments. In a financial system, where 80% of the trades have a duration of less than 20 minutes, second by second interest rate payments are more than a technical detail.

For instantaneous settlement to happen, we need to introduce electronic certificates, which make any asset easily transferable. The electronic certificates will be issued by the equivalent of notaries for property of land.

We also need to launch a global early warning system, which is organised along the same lines as Wikipedia. It will collect digital data of the real economy and financial markets from sources from around the world to generate online forecast and risk information. I envisage system like a huge economic weather forecasting service covering all aspects of our economy.

In the world economy, should investment strategies be changed? In which way?

We have to stabilise investment strategies: few people are aware that the buy and hold strategies that are recommended for all types of investors and the trend following strategies destabilise the financial system. The global economy is a complex system, which can only achieve stability, if financial assets are managed by market stabilising investment strategies. Central banks and sovereign wealth funds should use their collateral to trade counter-trend investment strategies and counter-act market excesses. I am not saying that central banks should target particular price levels, they should target a particular volatility regime and take positions, whenever volatility increases and prices overshoot.

Any reform regarding the investment products for the retail traders?

There is a need to develop user friendly investment products. I very

much believe in creating the equivalent of an iPhone for investment products – the products need to be designed in such a way that they are intuitive and user friendly; embedded in the financial products should be all the heavy lifting of intra-day decision taking and should be designed in such a way that they contribute to market stability.

Will analysts and traders be dependent on sophisticated technology to achieve absolute returns, or will basic tenets of technical analysis be preserved?

Practitioners developed technical analysis because the economists were not able to provide them the appropriate tools. This is changing. Finance has made a lot of progress and is gradually making available to the everyday man useful decision support tools that significantly improve the performance of retail traders.

Many citizens are criticising the lack of ethic of the traders and financial markets... Do you agree?

The insiders of financial markets know the inner working of the financial system and can use this knowledge for their own personal benefit, but at the expense of the society at large.

Insider manipulation is prejudicial and illegal. Do you think financial markets actors should be given a stronger sense of responsibility?

In medicine doctors have to swear the Hippocratic oath and are not allowed to abuse their power, we have to create awareness that all aspects of business have an ethical component, where we need to do the right thing: we are not allowed to embark on an action if it only benefits ourselves at the expense of the group at large or the whole society. We are only allowed to take actions that are also beneficial for society as a whole.

To conclude, Richard: are you bearish or bullish as for the future of the markets?

I could not be more bearish for the next two years. There are, however, solutions and we can turn things around. We need to have the courage for change.