TOO HOT TO HANDLE?

ASIAN CURRENCIES ARE RENOWNED FOR THEIR UNPREDICTABILITY. BUT UNDERSTANDING THE RISKS IS THE SECRET TO MANAGING THEM. VISHNU VARATHAN EXPLAINS

When addressing currency risks in Asia, it is important not to miss the wider point that heightened FX volatility swings appear to be the 'new normal' in the context of ongoing 'global rebalancing'. The confluence of economic/financial crises in the developed world, unprecedented, unconventional monetary policy response and a fundamental shift in debtor-creditor dynamics has demanded a rethink about global asset valuations. And FX is certainly no exception. Put simply, currency risks are not peculiar to Asia, or emerging markets for that matter. Rather, they are a global phenomenon.

Nevertheless, there are four aspects of Asian FX markets that perhaps magnify currency risks. The first is liquidity, or to be precise, the lack of. Asian currency markets are generally not as deep and liquid as those of developed markets. Consequently, not only are bid-ask spreads wider, but Asian currencies are rendered inherently more volatile. Secondly, there are more regulatory/political risks to contend with. Many economies in Asia are still in the process of liberalising their capital accounts, sometimes by trial and error. What's more, political stability is not always a given, while improvement in governance has some way to go. Thirdly, Asian economies are by and large export-dependent, accentuating FX sensitivity to global demand dynamics. In many instances, where the currencies are also not freely floated, this translates into hues of mercantilist policies coming through exchange rates. Finally, with a more 'flexible' Chinese yuan (CNY), Asian currencies could be more volatile, too. Ever since steady CNY appreciation policy took effect in mid 2005, Asian currencies have been increasingly predisposed to an appreciation trend – in tandem with deepening trade and investment linkages with China. But the days of one-way bets on yuan appreciation (*vis-à-vis* the US dollar) are numbered, if not over. Accordingly, this foretells more two-way FX forces in the offing.

Similar, but not homogeneous

There are, however, drawbacks to taking a broad-brush approach. An under-appreciated fact is that Asia is not homogeneous and neither are the associated currency risks. Asian economies are rich in nuances such as export dependence, fiscal/debt position, growth performance, inflation dynamics, level of development of financial and real infrastructure, monetary policy mechanism and political systems. All of these ultimately contribute to currency valuation. What's more, cross-Asia differentials are anything but static. The upshot is that any framework for managing Asian currency market risks must allow for two key factors. Firstly, the risks across Asia are dynamic, evolving in response to both structural and cyclical forces. And secondly, there is abundant scope for quality differentiation within the Asia FX space. Hence, there is a constant reordering of currency risk profiles in Asia, although some are generally more vulnerable than others.

For instance, the Indonesian rupiah (IDR) was by far the most volatile currency during the Asian financial crisis, plunging a heart-stopping 86% between Q2 1997 and Q2 1998. This was an obvious (with the benefit of hindsight, of course) consequence of an unsustainable investment bubble, inflated by massive (but light-footed) capital, bursting abruptly. Chronic current account deficits being financed by volatile capital, and worsening asset-liability mismatches in currency and duration, are telltale signs of impending trouble.

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In contrast, during the post-Lehman crisis, the South Korean won (KRW) took the hardest knock, dropping almost 35% between mid 2008 and Q1 2009. This was mainly due to the initial shockwaves that were triggered by a freeze in trade-finance and interbank liquidity. Hence, adverse FX shocks from the trade channel, given the highly export-reliant economy, were compounded by financial market shocks from rapid reversals in foreign funding.

More recently, the Indian rupee (INR) has emerged as the runaway underperformer, tumbling 20% since mid 2011. INR woes are due to a toxic combination of high oil prices adding insult to the 'twin deficit' problem (a trade deficit and budget shortfall); political gridlock amid policy missteps and the conundrum of slowing growth alongside 'sticky' inflation.

Finally, the Vietnamese dong (VND) highlights another facet of currency risk: policy devaluation. For example, when most Asian currencies were

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appreciating (1-3%) in Q1 2011, VND tumbled some 7% due to a policy-imposed step-devaluation. Market pressures often trigger policy devaluations and, although they are deemed necessary to correct economic imbalances, they undermine confidence in the currency nevertheless.

Evidently, there are some notable common threads pertaining to currency risks. These include: the health of external balances; indebtedness; policy positioning; and political threats. At the risk of oversimplifying, exchange rates reflect the traded value of an economy. In that vein, the above-mentioned factors represent the sovereign equivalent of corporate balance sheet, income and cash flow and strategic/event risks.

In Asia, freely floated currencies are the exception, not the rule. To some extent, scars from the Asian financial crisis predispose against freely floating exchange-rate regimes. Most of Asia operates on a scale traversing currency pegs to 'managed floats'. With the exceptions of Singapore and Hong Kong (both financial centres), the rest of Asia, to varying degrees, lacks full capital mobility. Exchange controls are necessarily a double-edged sword. On a positive note, these controls sometimes offer stability (for example, the CNY). Nonetheless, regulatory compliance costs and red tape can add to the frictional costs of doing business in some parts of Asia.

Get a grip

In order to manage currency risks in Asia, it is important to first recognise these risks correctly. So, good, old-fashioned optimisation of cash management is imperative. This entails optimising the foreign currency to Asian currency cash buffer as well as delicately balancing Asian currency revenues with liabilities. In addition, employing a variety of hedging tools (non-deliverable forwards, forwards, options and swaps) adds to the arsenal of currency risk management. Finally, it is imperative to stay on top of regulatory changes. In addition, keeping abreast of macro risks helps to determine the direction of FX/liquidity policy.

This brings us back to where we started: global macro risk, dominated by the rolling European debt crisis. Admittedly, negative global demand or financial shocks will initially undermine export-oriented Asian currencies. Nonetheless, devaluation of European assets alongside euro and US dollar debasement risks (from policies tending towards debt monetisation) will prompt a reallocation of global FX reserves – with a significant portion belonging to Asia. For a lack of alternative, and to better reflect growing intra-Asia commerce, cross-holdings of Asian assets will inevitably grow. In turn, this should prompt more enduring appreciation in Asian currencies further out, ultimately leading to greater currency stability. But for now, until the dust settles, volatility is the order of the day.

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THREE MANIFESTATIONS OF CURRENCY RISK IN ASIA

VALUATION

This is probably the most prominent 'headline' risk. Sudden shifts in FX valuations due to global macro or country-specific factors can have a potentially huge income and balance sheet impact. Significant depreciation in the INR over the past 12-15 months is a more gradual version versus sudden VND devaluations.

LIQUIDITY

The ability to seamlessly convert Asian currencies at an acceptably low cost cannot be taken for granted. This constraint arises from capital controls undermining FX funding in domestic markets or simply due to the lack of depth in the local market. One example is the strain on US dollar funding in Vietnam's banking system.

REGULATION

Given the ongoing capital market deregulation in many parts of Asia, changes to FX regulation come with the territory. The more benign are incremental tweaks to policy, such as restrictions on non-trade FX dealings and permissible FX hedging. Not as common, but of far greater impact, are abrupt impositions of capital controls, such as those in Malaysia, during the Asian Financial Crisis, and Thailand, following the coup in 2006.